SIA
SECURITIES INDUSTRY ASSOCIATION

TRENDS

An Analysis of Emerging Trends in the Securities Industry
Produced by the SIA Research Department

Vol. XV, No. 7 December 29, 1989

RETROSPECTIVE ON THE EIGHTIES; PERSPECTIVES FOR THE NEXT DECADE

Substantial changes occurred in the securities industry during the Eighties. This issue of Trends focuses on and quantifies these changes while attempting to put into perspective what these changes portend for the industry in this century's final decade.[1/]

Growth & Contraction During the Eighties

The Eighties were a decade of fantastic growth for the securities industry but more recently, a time of contraction and consolidation. Average daily volume on the Big Board climbed from just tens of millions of shares in the Seventies to 189 million shares per day in 1987. This fell back 14% last year and recovered slightly by about 4% in 1989 (**Exhibit 1**).

The over-the-counter markets grew even faster, with NASDAQ daily volume rising from single-digit millions in the Seventies to 150 million shares per day in 1987. This also fell back last year, by 18%, but recovered half that loss in 1989.

[1/] Based on a presentation by Adrian L. Banky and Jeffrey M. Schaefer at SIA's 1989 Annual Convention. SIA welcomes contributions to Trends from all sources, including member firms and other sources on subjects relating to the securities industry and capital markets. Please send submissions to the attention of Jeff Schaefer or George Monahan, SIA Research Department.

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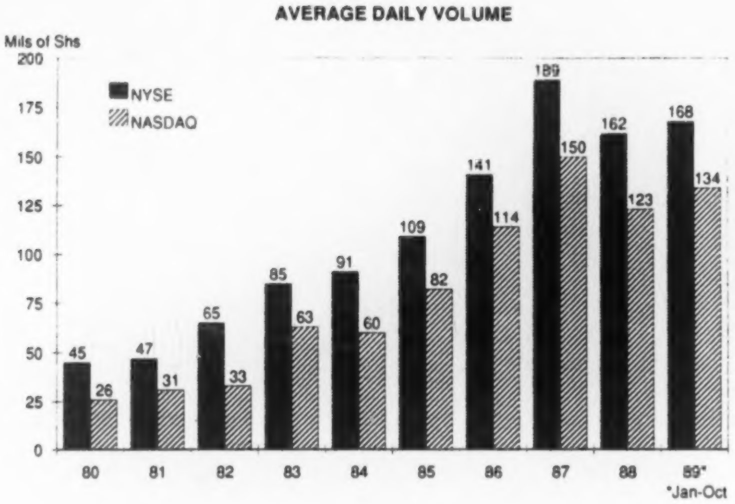
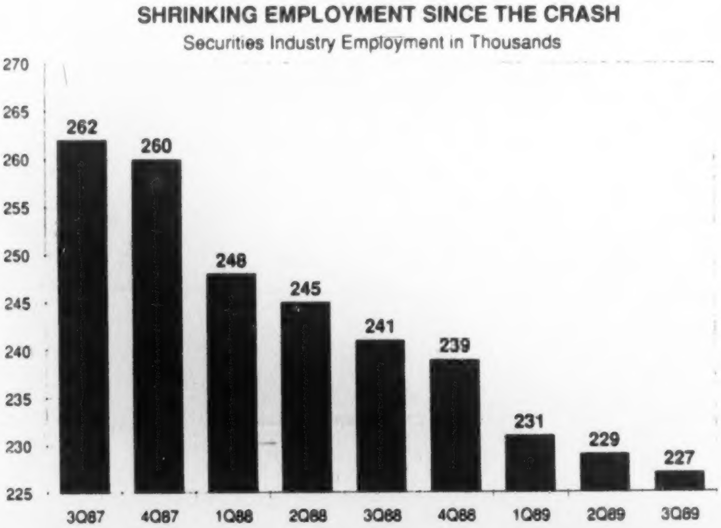
EXHIBIT 1



Any yardstick will show the growth of the securities industry in the Eighties. Industry revenues more than tripled from 1980 to 1986, going from $16 billion to $50 billion, but then stayed flat for the next two years. This year should show record industry revenues of about $60 billion - but these are not evenly spread among types of firms and have become increasingly risk-based, principal business driven.

Another growth/contraction area is employment. Since the October 1987 crash, employment has dropped sharply in the securities industry. For NYSE firms dealing with the public, total employment has declined from 262,000 as of September 1987 to 227,000 as of September 1989, or 13% (**Exhibit 2**). Although half of this decline was completed by 2Q88, further cuts have been announced recently.

EXHIBIT 2



Though industry employment is down at least 35,000 in the two short years since the October 1987 crash, a look back at the early Eighties shows a dramatic increase in securities industry employment. The number of employees increased from 140,000 at year-end 1980 to 227,000 at 3Q89 (**Exhibit 3**), with a peak of 262,000 during 3Q87. Employment exploded by almost two-thirds during the decade despite the post-crash layoffs.

EXHIBIT 3

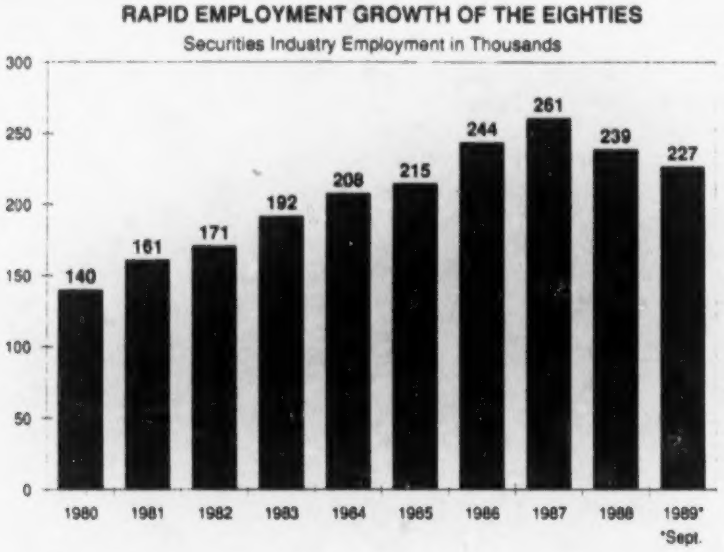
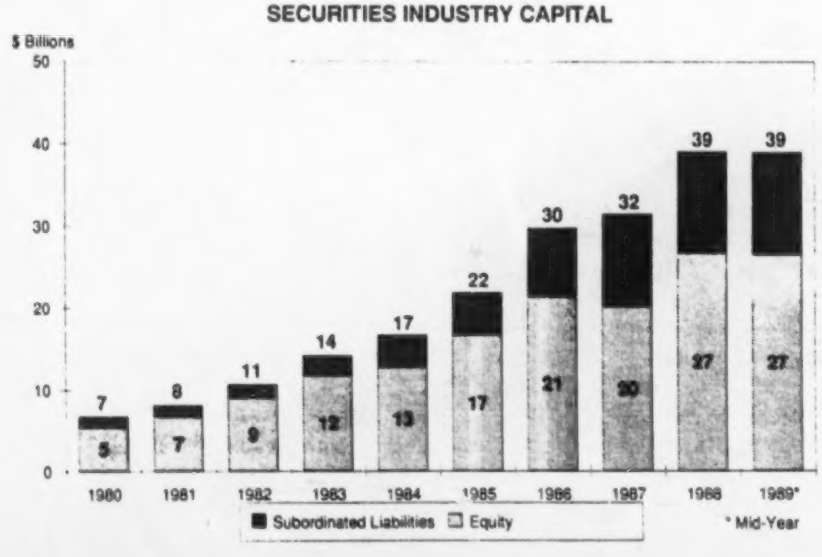


Exhibit 4 shows how industry capital (equity plus subordinated debt) quintupled from $7 billion in 1980 to $39 billion today. And this just includes the broker-dealer units of NYSE members. Excluded from the numbers is capital at the holding company level which increased sharply in recent years according to the reports of publicly held companies.

EXHIBIT 4

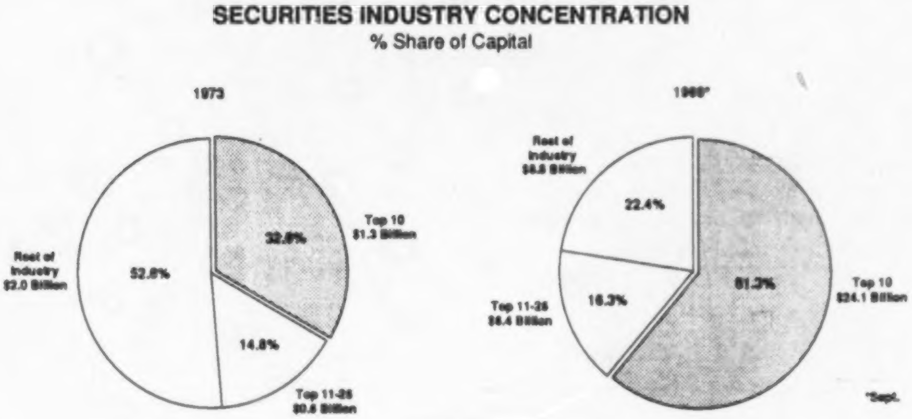


The demand for capital increased greatly during the Eighties as the industry, particularly the larger multinational firms, delved deeper and deeper into their own pockets to finance principal businesses - trading, merchant banking, bridge loans, sole-managed underwritings, participation in ownership of commercial enterprises, etc.

When the self-supplied capital became scarce, a new supply came from a rash of IPOs - we now have about three dozen publicly held SIA members vs a handful in the Seventies. Also, alliances with other institutions, particularly insurance companies, and most recently large Japanese intermediaries, have become an important source of capital.

This capital growth has been throughout the industry but, again, not evenly distributed. **Exhibit 5** shows how the largest 10 capitalized broker-dealers had just over $1 billion of capital in 1973 -- or 33% of the industry total. By September of this year, the largest ten's capital had grown 18-fold and accounted for over 61% of the industry's capital. The fifteen next largest firms had a 10-fold increase in their capital over this time span and maintained their same 15-16% share of industry capital. Meanwhile, the bulk of the industry in terms of number of firms had less than a five-fold increase in capital. In 1973, the rest of the industry, 419 firms, accounted for over half of all industry capital. This year, they account for 22% of the total.

EXHIBIT 5



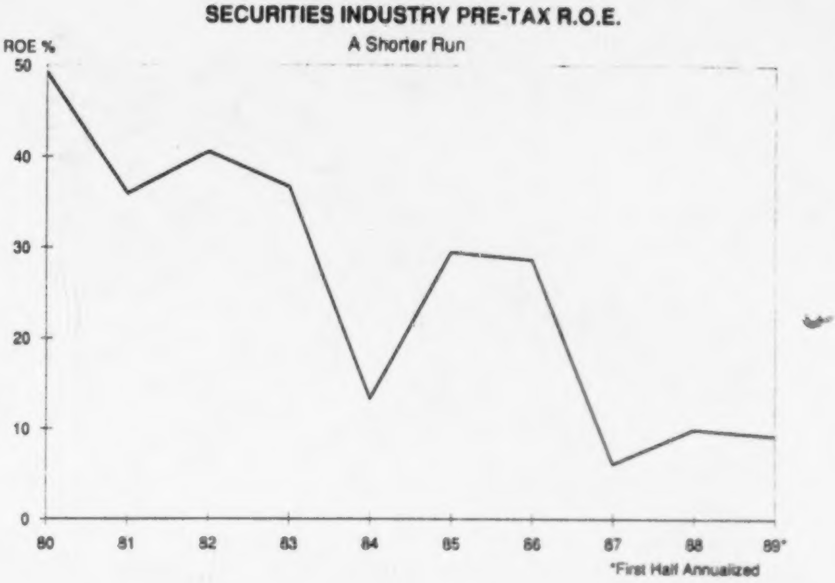
SECURITIES INDUSTRY CONCENTRATION

% Share of Capital

Recently, some concerns have been voiced that the industry is becoming over-capitalized. Certainly the diminishing returns being earned on the growing capital base may indicate that the industry has too much capital, or at least that it not being employed effectively.

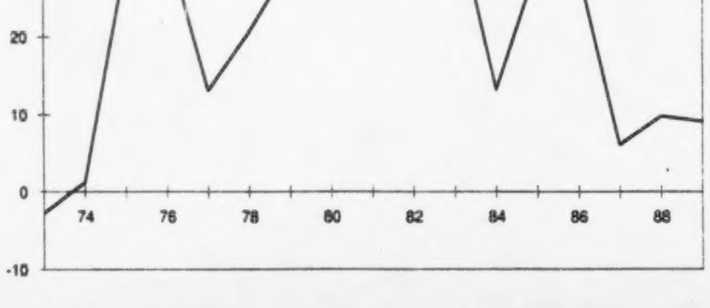
During the Eighties, industry ROE plummeted from a high of 50% in 1980 to a dismal of 6% - 10% since the crash (**Exhibit 6**). The downward trend was well under way during even the very good years in the early-to-mid Eighties. This trend coincided with the capital build-up and raises the question of can additional capital generate as high a ROE as the first units of capital. It is not easy to manage larger organizations so they are as efficient in generating profits as they were when they were much smaller.

EXHIBIT 6



An even longer-term look at ROE back to the 1970s suggests that we may simply be in the downward part of a cyclical earnings pattern in this industry (**Exhibit 7**).

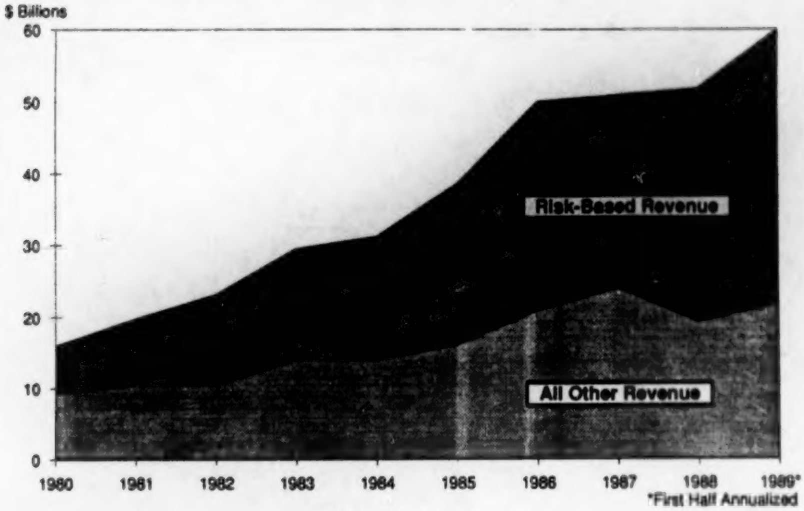
EXHIBIT 7



Also, additional capital may be employed not in less productive businesses, but rather that the industry's traditional, non-capital intensive businesses were dragging overall earnings and ROE down. In fact, for most firms, the more profitable segments of the industry in recent years have been those that are most capital intensive. Risk-based revenues now account for almost two-thirds of all industry revenues and that trend seems to be inevitably growing (**Exhibit 8**).

EXHIBIT 8

SECURITIES INDUSTRY ALTERED REVENUE BASE



This trend implies that instead of being overcapitalized, firms may require even more capital if they seek to pursue the more profitable segments of the industry in the Nineties.

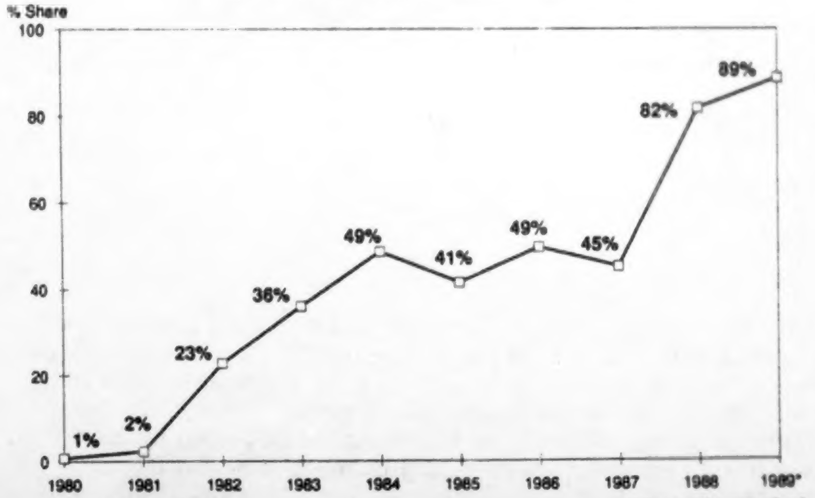
These risk-based revenues include: underwriting and trading revenue combined with "other securities related" revenues (private placements, M&A fees and interest revenues other than margin interest).

Not only have these risk-based revenues increased relative to other revenue sources, they increasingly are becoming more concentrated among the largest firms because of the heavy capital commitment most risk businesses require.

The trend towards principal trading and merchant banking has also helped change the way other business is done. For example, 89% of the value of bond underwritings so far in 1989 are completed without syndicates (**Exhibit 9**). That

EXHIBIT 9

NON-SYNDICATED SHARE OF
VALUE OF U.S. DEBT UNDERWRITINGS



Source: Securities Data Co.

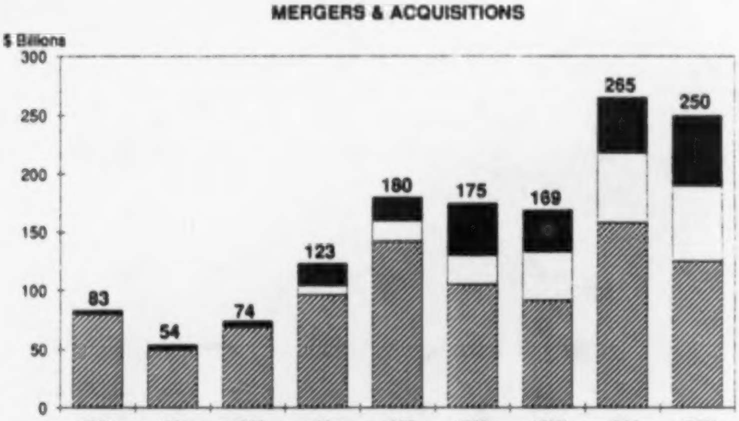
*Nine months annualized

compares with under 50% from 1984-1987 and even smaller percentages in earlier years. Even one-third of equity underwritings are now completed without syndicates, although this level has remained more or less constant throughout most of the Eighties.

Of all the risk-based businesses, one of the fastest growing segments for the securities industry this decade is related to merger and acquisitions (M&A). Although dominated by National Full Line firms, Large Investment Banks, boutiques and money center banks, M&A has contributed a large and growing portion to the industry's bottom line -- and not just from direct advisory fees. Firms are now taking equity positions in these deals, providing bridge loans, underwriting high yield bonds and earning a host of other ancillary fees.

Although there has been some recent leveling off in this area, even if the most profitable segment, LBOs, begins to quiet down, the fastest growing segment, cross-border M&A, is now showing the fastest growth and is sure to be a major profit center in the 1990s (**Exhibit 10**). Japanese and European direct investment in the U.S. is just now beginning to soar, and with the recent events in Eastern Europe and the hope for the EEC in 1992, the potential for future cross-border M&A is very promising.

EXHIBIT 10

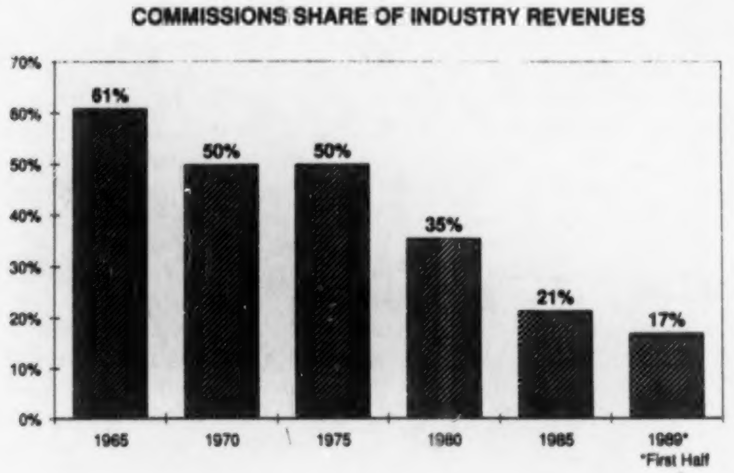


Source: Sanford C. Bernstein & Co.

* Estimate

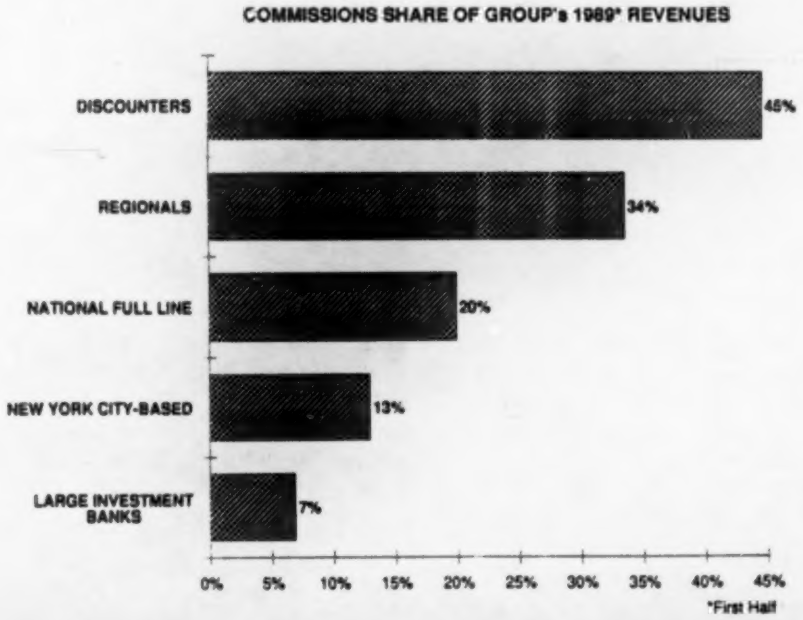
The growth of these risk businesses has dwarfed the growth in traditional businesses, primarily commissions. This trend, combined with the declining relative importance of equities domestically and U.S. equities internationally (not to mention the proliferation of other products), has led to a decline in the importance of the securities industry's traditional largest revenue base, commissions. **Exhibit 11** shows that over 60% of all revenues came from commissions in 1965. Today, commissions account for not even 17% of total industry revenues.

EXHIBIT 11



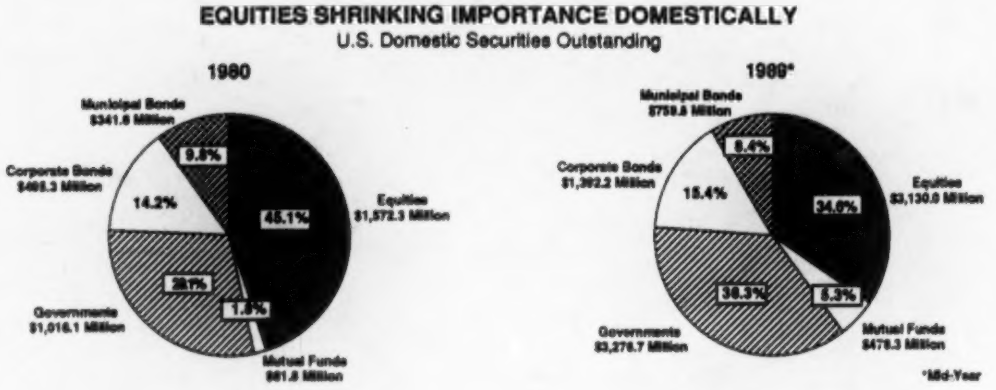
This 17% is partly due to other fast increasing business lines of the largest, dominant firms - - Large Investment Banks and National Full Line Firms - - where commissions account for only 7% and 20% of total revenues, respectively (**Exhibit 12**). Regional firms still derive one-third of their revenues from commissions, but even discounters today are reporting less than half of their revenues as equity commissions. Principal market making, including OTC positioning, accounts for some of the loss of the importance of exchange listed commissions, but the move to principal markets in debt instruments and fee-based revenue growth accounts for most of the change.

EXHIBIT 12



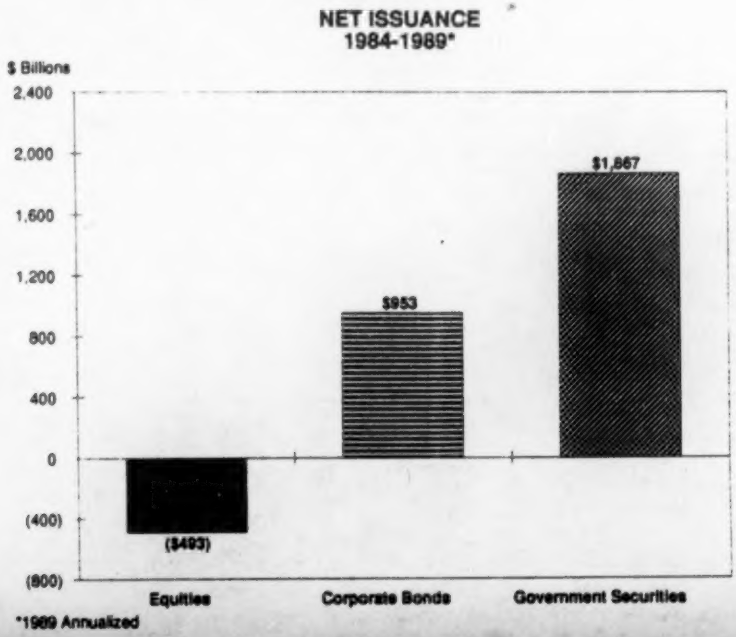
There are other implications for firms concentrating on the equity commission business. Marketable securities held by U.S. investors, both institutional and retail, almost tripled from $3.5 trillion outstanding in 1980 to $9 trillion as of mid-year 1989. But, again, the growth has been uneven, across securities. Equities, which historically dominated all securities outstanding, accounted for nearly half of the value of all securities in 1980 (**Exhibit 13**). By mid-year 1989, equities fell to the #2 security, behind U.S. Government securities, mainly Treasuries, and accounted for only a third of the outstanding value of all securities.

EXHIBIT 13


EQUITIES SHRINKING IMPORTANCE DOMESTICALLY
U.S. Domestic Securities Outstanding

This shift in the importance of equities is a basic change in our capital markets and has been triggered by the shrinking supply of equities (**Exhibit 14**). However, this trend may have limits. Leverage today may be no higher than in some past years but it is relatively high. The markets are showing some unease with

EXHIBIT 14


NET ISSUANCE
1984-1989*

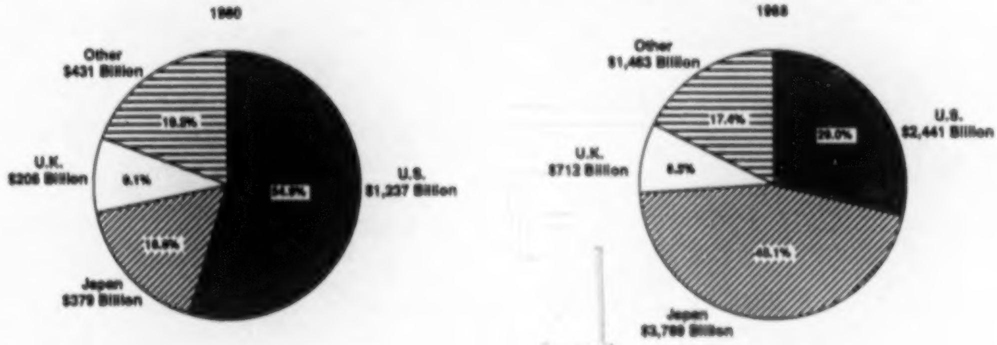
recent leverage levels, i.e. the skittish junk bond arena. At some point, equities may return to favor, particularly if tax laws are revamped to fall more in line with the tax treatment of equities in most other developed countries.

Equities not only have fallen in relative importance in the U.S. market, but their once premier position in the world has been eclipsed. In 1980, U.S. equities commanded 55% of the world's equity market capitalization and Japan only 17%. Last year, Japan's capitalization gave Tokyo a 45% share of world equities and the U.S. a mere 29%! (**Exhibit 15**) U.S. equities did grow but only two-fold while most of the world grew four-fold and Tokyo grew 10-fold! Part of Tokyo's growth has been the strengthening of the Yen in the Eighties, but this has not been the most significant factor. With no end to Japan's growth in sight, with Europe slated to be a block in 1992, with the recent "equitization" of Europe, and with the enormous potential of European growth with East meeting West, the U.S. may never again dominate the equity scene as in earlier years and this will be a major consideration for institutional and retail investors.

EXHIBIT 15

U.S. EQUITIES SHRINKING IMPORTANCE GLOBALLY

Global Equity Markets Capitalization

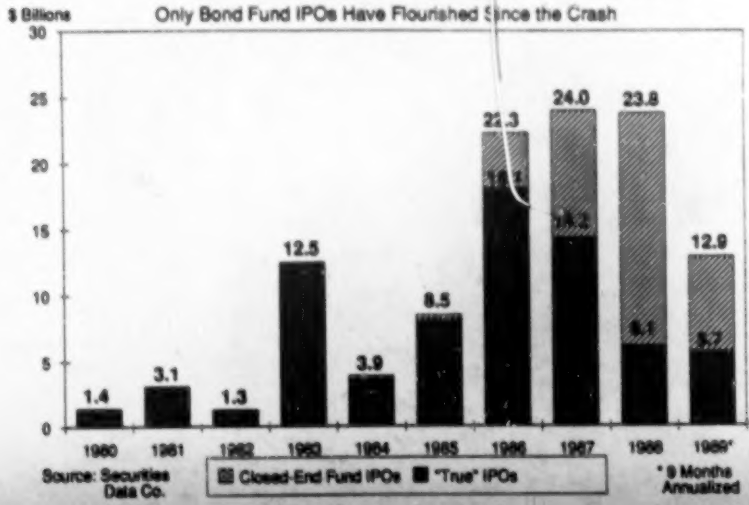


Since the 4Q87 crash, there is another factor affecting the decline in equities -- a dramatic drop in initial public offerings (IPOs). **Exhibit 16** shows how "true"

EXHIBIT 16

"TRUE" IPOs HAVE CRASHED SINCE THE CRASH

Only Bond Fund IPOs Have Flourished Since the Crash

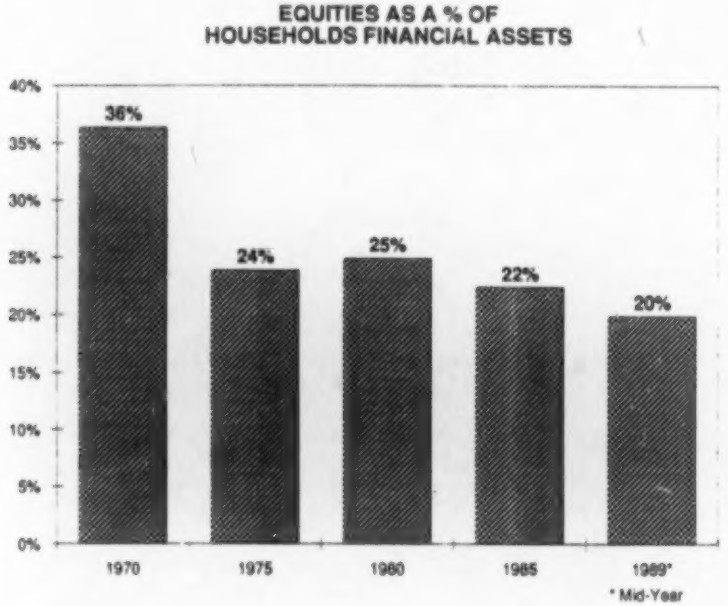


Source: Securities Data Co.

IPOs, companies going public and not including the recent surge (and now decline) of closed-end bond fund IPOs, has dropped to less than one-third their 1986 peak.

On the retail side, equities have also become a less important part of household's financial wealth over time -- dropping from 36% of financial assets in 1970 to under 25% by 1975 and down to 20% as of mid-year 1989 (**Exhibit 17**). This decline in relative importance occurred despite the value of stocks held directly by households growing from less than $700 billion in 1970 to over $2 trillion by mid-1989. Although households' equity value did grow, other financial assets held by households increased faster during this time span.

EXHIBIT 17

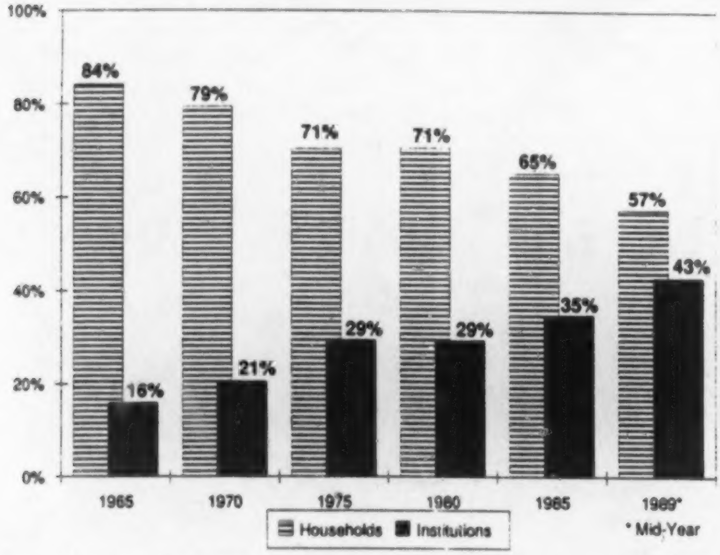


Where has the individual investor gone? Certainly, in the 1980s, households turned to those products offering attractive real interest rates. Money market funds enjoyed spectacular popularity. And, as individuals' direct holdings of equities dwindled, they were replaced to a certain extent by shares in mutual funds. Combined as a part of individuals' financial assets, these two investment vehicles grew by 17-fold between 1970 and 1989. Meanwhile, equities were the slowest growing component of individual assets, growing three-fold.

While individuals own a smaller share of equities directly, institutions own a larger share. Institutional ownership of equities has risen from 16% in 1965 to 43% by mid-1989 (**Exhibit 18**). For the equity markets, this has led along with other factors, to less liquidity and greater volatility.

EXHIBIT 18

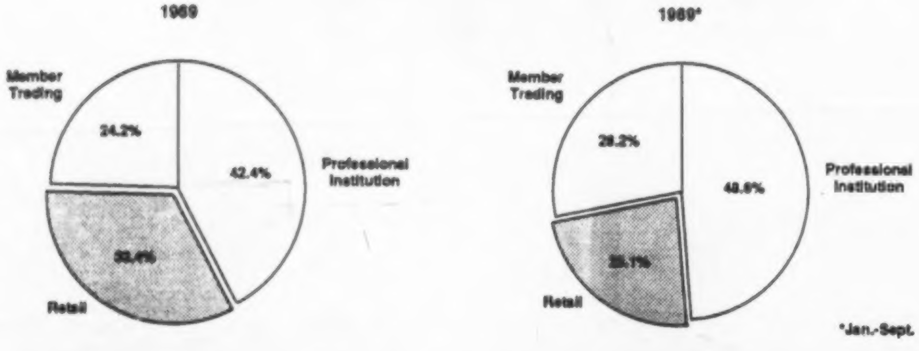
HOLDINGS OF U.S. EQUITIES



In addition, together with member firms trading as principal, institutional trading has gone from two-thirds of NYSE volume in 1969 to just under 80% during 1989 (**Exhibit 19**).

EXHIBIT 19

PROPORTION OF NYSE SHARE VOLUME



*Jan.-Sept.

The institutional business has also put severe pressure on firms' profit margins. Many firms are now unwilling to put capital at risk for block positioning given the plunge in institutional rates, and now there is a movement underway to unbundle research from commissions. A key question for the securities industry of the 1990s will be how to serve institutional customers while maintaining adequate profit margins.

As individual participation waned and institutional participation waxed, the equity market declined in relative importance as a capital raising mechanism. Corporations have turned increasingly to debt financing as net withdrawals of equities began in the mid-1980s and accelerated. As we've seen (**Exhibit 14**), by the end of 1989, almost $500 billion in equities will be withdrawn from the public markets while almost two times that amount of corporate debt will have been raised.

The future capital structure of corporate America may more closely resemble that of German and Japanese companies. However, those companies have very different relationships with their banks and governments which may be completely inappropriate for the U.S. where we want a separation of banking and commerce. The growth of institutionalized assets, the rise of index funds and other "non-fundamental" trading strategies have led to serious questions about the efficiency of pricing in our equity markets. However, the recent shakiness in the high yield bond market is starting to make many uneasy with the amount of debt accumulated by U.S. corporations and government.

While the individual investor has fled the market and corporate America turns more and more to debt financing, there is one sector with a growing appetite for U.S. equities -- and debt as well. **Exhibit 20** shows that, excluding the corporate demand for shares, foreigners are now the #2 net buyers of U.S. equities. This has been true over the long haul (the shorter bar for yearly average 1980-89) and even more so more recently (taller bar, 85-89). Foreign customers, therefore, may continue to be a growth base for the 1990s as in the 1980s.

EXHIBIT 20

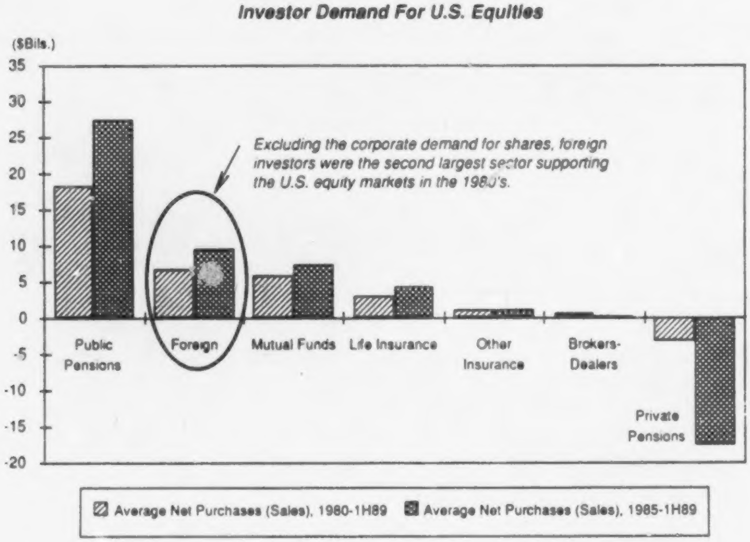
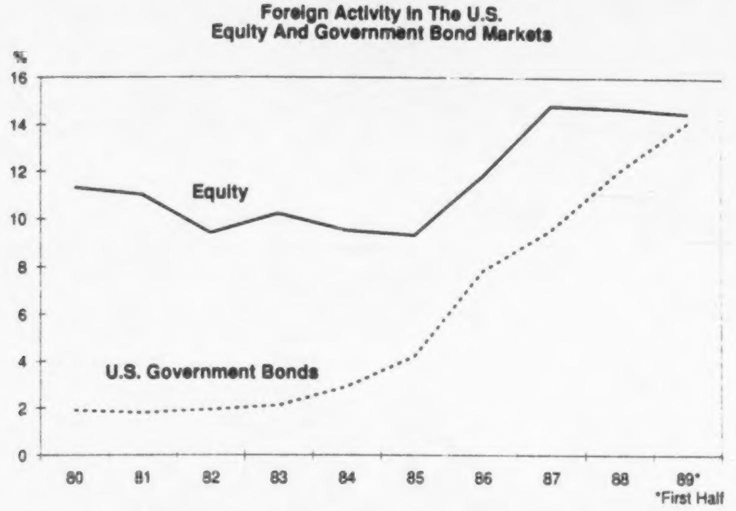


Exhibit 21 also shows how important foreigners have become to our U.S. equity markets -- recently accounting for 14% of the total trading done in the U.S. But the most recent rapid growth in foreign gross activity has been in the U.S. government bond market.

On an aggregate basis, foreign activity in governments has climbed from just under $100 million in 1980 to nearly a $4 trillion annual pace this year. Foreigners now account for over 14% of Treasury sales handled by primary dealers in the U.S. Indeed, Japanese and British firm names now pepper the short list of firms allowed to be primary dealers in Treasuries. As for T-Bills alone, there is now just over $2 trillion outstanding in the world with nearly $400 billion in the hands of foreigners. That is equal to two full years of federal government deficit spending.

EXHIBIT 21



With so much of our nation's debt in the hands of foreigners, can we have a truly independent monetary policy that doesn't take into account what the foreign demand for Treasuries is? The answer is obviously no. For instance, if the U.S. took an extreme action which caused Japanese institutions to unload their Treasury holdings in any sizable fashion, the Treasury would have to double interest rates in order to complete its next weekly auction!

The 1990s will see a more globally oriented economy and securities industry. The recent events in Eastern Europe will make this even more dramatic -- in ways which are very unpredictable. The securities industry does not now, and will never again, resemble exactly its history. The future success stories will come from firms which carve out a profitable niche in the increasingly global, diversified financial service industry of the Nineties.

The loss of the individual investor to the equity markets is a loss to all. Retail investors are a key buffer to the markets -- they buy and hold for real quality and for the long run. This is important to everyone.

The 1986 tax reform act exacerbated the exit of individual investors at the same time as it spurred greater corporate reliance on debt financing. By eliminating targeted tax incentives for savings and investment, that act eliminated distinctions on income from risk and riskless investments.

America's major international competitors have recognized the need to encourage equity investment by individuals. Of ten OECD countries studied in a recent tax survey published by SIA,[2] four completely exempt long-term capital gains and four apply rates lower than the U.S. (**Exhibit 22**).

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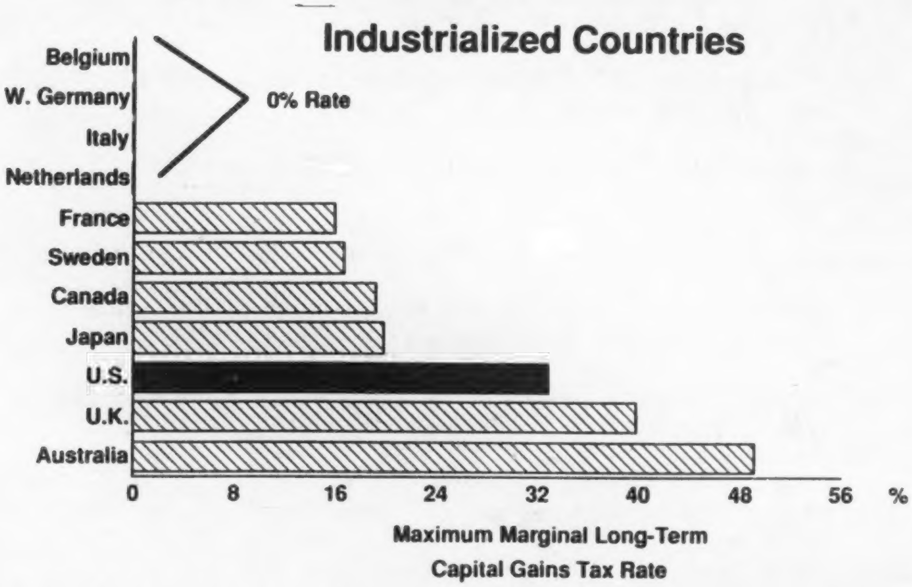
[2] Securities Industry Association and Spicer & Oppenheim, International Tax Comparisons, 1989.

EXHIBIT 22



Moreover, the double tax on dividends is alleviated by some form of corporate integration in eight of these countries (**Exhibit 23**). In general, savings and investment incentives are found specifically in the tax codes of most major countries - except the U.S.

EXHIBIT 23

U.S. One of Few to Double Tax Dividends

	Corporate/ Shareholder Integration
United States	**No**
Australia	***Yes***
Belgium	***Yes***
Canada	***Yes***
France	***Yes***
West Germany	***Yes***
Italy	***Yes***
Japan	***Yes***
Netherlands	**No**
Sweden	**No**
United Kingdom	***Yes***

The downward trend in the U.S. personal savings rate in the 1980s, the lack of participation in our equity markets by individual investors, and the increasing emphasis on global competition raises more than a few questions about our national policy towards savings and investment.

In summary, the Eighties, particularly since the 4Q87 have not been all moonlight and roses. Nevertheless, we must remember the many positive trends that occurred during this decade including:

1) volume on the NYSE almost quadrupling while activity on NASDAQ more than quintupled;
2) employment increased by almost 90,000 employees, or two - thirds;
3) capital quintupled to almost $40 billion for broker-dealer units only;
4) the industry is critical to the restructuring of corporate America which is absolutely vital to the global economy of today;
5) the revenue base has diversified and exploded from $16 billion in 1980 to $60 billion in 1989;
6) the value of equities on the NYSE has grown from $1.2 trillion in 1980 to $2.4 trillion as of mid-1989 despite an estimated $500 billion being withdrawn from the marketplace since mid-1983 because of corporate restructurings; and
7) the U.S. capital markets have become truly international as foreign investors have been attracted to them by their liquidity, rules of fair play, and opportunities.

Adrian L. Banky
Executive Vice President and
General Manager

Jeffrey M. Schaefer
Senior Vice President and
Director of Research

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An Analysis of Emerging Trends in the Securities Industry
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"THE INSTITUTIONAL BUSINESS IN THE 1990's"

REMARKS OF
RICHARD B. FISHER
PRESIDENT
MORGAN STANLEY GROUP INC.

I have been asked to discuss the institutional business in the 1990's. There are many different subjects that one can characterize as institutional business, and I do not want to oversimplify the subject. Many individuals involved with regional firms have unique opportunities in dealing with institutions with their own set of challenges and opportunities.

I want to cover the part of the business that is done with larger institutions. I will discuss the business as though it were one business, that is without making constant distinctions between fixed income securities and equities. That would not have been possible two or three years ago because there were some very important divergences in those two major segments, but it seems that those two businesses are more and more experiencing similar difficulties for many of the same reasons.

Based on a presentation by Richard B. Fisher, President, Morgan Stanley Group Inc. at SIA's 1989 Annual Convention. These remarks were edited by Jeffrey Schaefer for written form purposes only. SIA welcomes contributions to Trends from member firms and others on subjects relating to the securities industry and capital markets. Please send submissions to the attention of Jeffrey Schaefer, SIA Research Department.

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All institutional businesses are now under maximum pressure. There are several reasons for this. First is a very simple one that we all learned in our basic economics textbooks in college, at least for those who bought the book, namely that any long period of reasonable prosperity in a business segment will attract excess investment; and that, of course, is what happened. We have substantial overcapacity in the institutional businesses in both fixed income and equities today because of normal business cycle reasons.

Beyond that, though, securities firms seem willing to accept poor returns in institutional businesses longer than they should by any standard of rational economic analysis. I cannot explain this phenomenon but I want to suggest a few reasons.

Some firms do not know their costs. They are in a business that is revenue oriented and has been for years. The amount of times a decision is based on both revenue and cost information in our business is less than it should be.

Some firms may have valid commercial reasons for, in effect, over investing in the institutional business. For instance, a certain type of firm may need to have distribution in place in order to be competitive for capital markets financing. You can not in today's world be the lead manager in a significant financing, if you can not deliver on the distribution side.

The next factor, which really ties into the second explanation, is that many securities firms continue to be market share and volume oriented and not enough oriented toward what the long-term earnings prospects are for any given level of investment in the business. Probably the most classic example occurred a few years ago in London. We were all given an opportunity when the Bank of England announced that they were going to increase the number of authorized dealers in the gilt business, the most important part of the government securities business in the U.K. At that time, there were eight authorized gilt dealers, and the number was to be increased to somewhere between 30 and 35, depending upon how many firms applied. We discussed this possibility for a long time at Morgan Stanley, and it seems to us from material contained in a very detailed 30 page memoranda that going from 6-30 dealers in a business not increasing in volume led to fairly obvious conclusions. It was not a business to enter.

The Bank of England had many more applications than they needed to expand to over 30 dealers, and a group of firms was given permission. Sure enough, over the next period of several years, less than 5 firms could claim a reasonable return in the gilt market. That type of event seems to happen regularly in our business which is volume, revenue and market share oriented.

My conclusion from this discussion is that we have substantial overcapacity of both people and capital in the institutional business. It is difficult to suggest the percentage of overcapacity. However, I want to try in order to give you some idea of what we have in mind. It is surely not marginal. My guess is it is something like 20 to 25 percent too much capacity in those businesses.

The second major point, which is just as important, is that the problem is not going to be fixed by cyclical increases in volume. I do not see any realistic estimate of volumes and of revenue/cost relationship in the next three years to justify today's level of investment. We have got overcapacity regardless of what happens to volumes of transactions going forward. The business cycle will not bail our industry out.

There are a number of other factors which we will cover quickly because you have other sources of information which most industry representatives are familiar with. The first is the increasing commoditization of large sectors of the business. Obviously, technology has had a major influence on this trend. I was standing behind one of our government traders the other day and he had eleven screens at his trading position with different kinds of information. I said, "Gee, that is terrific!" He said, "No, it is not. I have got eleven. The customers have twelve." That pretty much summarizes the impact of technology in the commoditization of certain kinds of business. Market information is not a way to add value today. There is no scarcity of sources of market information.

The next fact that has been a very negative factor for certain firms is the whole soft dollar 28E situation. It is a loaded subject, and many people have different views on it, but let me give you one fact. Since October of '87, the NYSE volume is down 10 percent, on average. In comparison, the full-service firms' listed commissions are down 40 percent in that period. In other words, the major full service firms are bearing the brunt of the soft dollar increase to boutiques, which is very simple to understand. Soft dollars become fixed payments. They are the first obligations that asset managers need to discharge, and the full-service trading and research firms are moved further and further down the line, both in terms of levels of revenue and order flow quality.

The large trading firms have had a major decline in the quality of the order flow they see. We simply do not see 2,000 shares of Telephone to buy or sell. That goes to the third party soft dollar vendors because presumably it is an execution that can be dealt with easily. In any event, this is a major problem for us and other firms similar to ours. It is one that has received the attention of regulators recently and probably will continue to, and it has a major negative impact on the institutional business.

The other factor is that more assets are being shifted into passive money management strategies. Institutions are trading portfolios rather than stocks, and they simply will not pay for services that focus on stock selection. As more and more assets become managed through passive strategies, the marginal value of stock selection information lessens.

Furthermore, there are a whole host of reasons that put further pressure on both commission and trading levels, and all of that combined summarizes the reasons behind why institutional businesses are in the poor shape they are in today.

Let us look forward a bit. My basic theme is that we are going to see a major change in the institutional business as time goes on. The simplest way to express this trend is that we will see the final move away from earned agency commissions or dealer order flow in return for providing market information. This is not a viable business today, and it is going to be increasingly more obvious that it does not have any chance of existing as a profitable business in the future.

What will replace this particular business is that money will be managed very differently in the '90's, and we, as intermediaries, have to find ways to add value. There is no question that there will be opportunities. It is not that money managers in the '90's are not going to need any help by any means. It is simply that they will need a different kind of help; and if we do not adjust to that quite substantially, we will see a continued decline in the profitability of institutional businesses.

Let us look at the few things I think will cause this complete shift. The first is globalization. We have been reading about globalization for 12 years now. This may lead some people to conclude that globalization is over. But, if you look at the facts, it has hardly begun. In our view, it will continue, at the very least, to be the dominant trend in world financial markets and will generate very large trading volumes.

There is more and more international money available for flows every day. In other words, as Japanese equity prices, for instance, are more and more priced by international flows and less and less by domestic Japanese flows, we are going to see a very large statistical arbitrage around the world. That is going to create enormous volumes for all of us to have access to as intermediaries. But this order flow will be done with firms for very different reasons than in the past.

The second factor is that interest will continue to move away from conventional cash markets for financial assets. By that, I mean complicated strategies will be used by global investors including the use of options and futures. It will have to do with currency related investments, whether it is bonds that have interest payments in one currency and maturity payments in another, tremendous shifts toward innovation and new kinds of instruments. It will also include the use of commodities and precious metals with financial instruments related to them. The list is very extensive as to why I think interest on the part of global money managers will continue to shift away from simple, conventional cash markets to other markets.

A further point has to do with changes taking place with institutional customers. There has a lot going on with them, and obviously it is important to understand what is happening to asset managers in terms of their own business requirements. In my opinion, the margin pressure of the '80's on the securities industry is going to shift, or at least spread, to the asset management business in the '90's, for several reasons.

The first is that assets will continue to migrate to lower margin sectors from the asset manager's point of view. In other words, the fees involved in passive management are substantially below the fees involved in active management; and as more and more assets shift in those directions whether its 100 percent passive or quasi-passive or asset allocation strategies, such shifts have negative implications for the operating margins of asset managers.

Secondly, I think assets will continue to move in house, back to the owners for the simple reason that passive strategies are much easier for large private pension plans, for instance, to manage in house.

Finally, the declining profitability of our institutional businesses is going to have implications for our institutional customers. Sooner or later, we will stop providing services - whether it is research or liquidity or first-rate sales services, etc. because we simply will not be compensated for them. That is going to move costs internally to the asset mangers. They are going to have to replace those services in one way or another.

As a result of all these trends, our market will continue to be institutionalized. I think the number of participants will decrease on both the buy and the sell side as the capacity corrections assert themselves; and, as I say, as more and more managers want to buy and sell portfolios and not stocks. If the picture that I have outlined turns out to be reasonably accurate, we will have to learn to live with an increase in price volatility.

There are two ways to regard volatility. The first is that increased volatility is simply unacceptable and terrible and we have got to do something about volatility in a legislative sense. Or you can look at it as an inevitable characteristic of markets under certain conditions and volatility is like any other problem. It has both severe problems and substantial opportunities for organizations that will try and learn to deal with volatility. Instead of volatility taking advantage of you and your firm, look for ways to incorporate assumptions about volatility into your business. Firms must find ways where they are able to reduce or eliminate the impact of or take advantage of volatility.

To summarize, I think that the rate of change in the institutional business will increase in the '90's. I think capacity reduction is necessary for us in the institutional business. It is going to develop in the future by firms getting out of businesses rather than simply cutting back. Again, it will not only be further reductions of head count in existing businesses. That is behind us. A lot of firms have reduced their number of employees in certain businesses, but I do not think we can get the percent reduction that is necessary by more of that.

We are going to see firms exiting businesses completely, frankly, much like what happened in London about a year ago. Morgan Grenfell got out of the equity business completely. That was a major decision for a major U.K. merchant bank to say that "we are not going to try to deal with this problem by reducing further our head count." They got out of the business, and as they say in London "made 480 people redundant." In this country, if you are redundant, it means you are fired.

One of my conclusions is that no one will continue to be able to earn reasonable returns by simply providing market information and executing agency trades. It is going to be much more complicated than that, and I think the following changes is what it is going to take. Institutional business managers will have to be very flexible in thinking about what their client wants because that is constantly changing. The clients are going to want something different in th '90's than they needed in the past; and, of course, the toughest part is to try to figure out what they will pay for. That creates two levels of difficulties. First, you have to know exactly what it is they will judge as having added value; and secondly, you have to make some judgments about how your organization will get compensated at levels that will enable you to earn a fair return.

Moreover, you have got to know your costs. A major change has to occur in this area and I do not think our industry has done enough work on this subject. At the larger institutional end, you have to think globally. Globalization has just begun, and we are not even close to understanding what the implications of globalization are for financial institutions around the world. It is going to be a very powerful trend in the future as, in fact, portfolios become globalized.

There are two problems with the global trend. One is the high cost of doing business globally. There is no question about these costs; but what you have got to focus on is not lamenting the high costs but figuring out how to get your cost structure competitive. Like any other business challenge, there is a way to deal with it.

The second problem, of course, is that many of the firms you compete with on a global basis are very large. We have heard a great deal about the size of Japanese firms but I think U.S. firms, in spite of their relative lack of size compared to large Japanese firms, are very competitive.

Finally, you have to be committed to using technology. This is something we hear about all the time. Very few of us really know what it means, but we have got to think it through. We have got to use technology intelligently, both to make better decisions and to get costs down.

Let me now finish on an up note because it is something that I really believe in. The securities business was in great difficulty many times in the past. There has been at least five bad cycles. In fact, when I told the placement officer at the Harvard Business School that I was going to join Morgan Stanley, he said, "do not do that. They are not going to be needed in the future." He also said to join Morgan Stanley required three things in 1962. He looked at me and he said, "You have to have blood, money and brains, and at best you have got one of those."

In any event, I really think that our industry is going to deal with the set of problems that we have been through as history shows at least five times already in my career. This industry has one of the greatest collections of entrepreneurs in any business in the world. We will figure our problems out as we have done many times before. In spite of the fact that there are some severe problems facing us now in terms of structure, there is also no question in my mind that the volume of business and transactions in the financial markets are going to be very favorable in the '90's. The firms that figure the problems and opportunities out are going to have some very interesting rate of return opportunities during the next decade.

PRICES
(END OF MONTH)

	DEC. 1989	DEC. 1988	% CHG DEC. 1989-1988
DOW JONES INDUSTRIALS	2753.20	2168.57	26.96%
STANDARD & POOR'S 500	353.40	277.72	27.25%
NYSE COMPOSITE	195.04	156.26	24.82%
AMEX MARKET VALUE INDEX	378.00	306.01	23.53%
VALUE LINE COMPOSITE	258.78	232.68	11.22%
NASDAQ COMPOSITE	454.82	381.38	19.26%

YIELDS
(MONTHLY AVERAGES)

	DEC. 1989	DEC. 1988	BASIS POINT CHG 1989-1988
BOND BUYER INDEX (20 BOND)	6.98%	7.61%	(63)
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	8.86	9.57	(71)
Baa CORPORATE	9.82	10.65	(83)
RATIO Aaa CORPS. TO Baa CORPS.	0.90	0.90	0

VOLUME

	DEC. 1989	YTD 1989	DEC. 1988	YTD 1988	% CHG YTD 1989-1988
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	160.7	165.2	135.5	161.5	2.3%
AMEX (MILS.)*	13.2	12.4	11.1	9.9	24.8%
NASDAQ (MILS.)*	138.0	133.0	118.5	122.8	8.3%
REGIONAL EXCHANGE (MILS.)*	27.2	26.4	24.5	23.3	13.2%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$110,991	$1,542,847	$91,202	$1,356,051	13.8%
AMEX (MILS.)	3,365	44,401	2,184	30,922	43.6%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	9,630	121,090	7,281	86,210	40.3%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	14,534	202,571	16,497	181,894	11.4%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	51.0%	51.1%	51.1%	54.2%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	7,799	126,765	8,305	111,784	13.4%
AMEX OPTIONS	3,380	42,576	2,629	37,470	13.6%
COMMODITY	16,567	267,385	18,494	245,871	8.8%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

UNDERWRITING

	FULL YEAR 1989	FULL YEAR 1988	% CHANGE 1989-1988
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$309,351.9	$274,943.2	12.5%
Common Stock	$23,173.4	$29,820.5	-22.3%
# of Common Stock Issues	470	420	11.9%
Preferred Stock	$7,591.6	$7,400.5	2.6%
# of Preferred Stock Issues	105	123	-14.6%
Corporate Debt	$278,586.9	$237,722.2	17.2%
# of Corporate Debt Issues	4158	3115	33.5%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$88,157.0	$87,720.7	0.5%
# of Issues	4252	4149	2.5%
Competitive	$29,812.1	$26,873.3	10.9%
# of Issues	3599	3695	-2.6%

Source: IDD Information Services Inc.

Item	Description	Source
U.S. Trade Protection: Effects on the Industrial and Regional Composition of Employment	Proponents of trade protection argue that trade restraints bolster overall employment. Although trade protection generally increases employment in the protected industry, it tends to reduce employment in other industries. This study measures the effects of trade restraints on the distribution of employment across industries and regions of the United States. The study examines the impact of trade protection on the textiles and apparel, steel and automobile industries.	Federal Reserve Bank of Dollars Public Affairs Department Station K Dallas, TX 214/651-6289 January(990-9552)
"Global Finance and the Retreat To Managed Trade"	The competitiveness debate that today focuses on industrial performance will soon confront something even more fundamental: money. The rise of foreign financial powers, particularly the Japanese, and U.S. economic problems threatens one of the few sectors in which the U.S. is more creative, sophisticated and aggressive than its rivals. This article explores the competitiveness of the U.S. financial services industry and the movement toward managed trade.	Harvard Business Review Harvard Business School Tele Hall Soldier's Field Road Boston, MA 02163
"Shareholder Rights Abroad: A Handbook For The Global Investor"	This handbook probes the extent of shareholder's rights in nine of the largest non-U.S. equity markets. It is designed to provide institutional investors with an analysis of the issues arising around foreign shareholding, together with a country-by-country index of opportunities and restraints affecting investor activism.	Investor Responsibility Research Center 1755 Massachusetts Avenue, N.W. Washington, DC 20036
International Tax Comparisons	Prepared in conjunction with Spicer & Oppenheim, this study provides and overview of the taxation of gains, dividends and interest on portfolio stock investments of individuals in the U.S. and ten other industrialized countries and six Pacific Basin countries.	Securities Industry Association

Japan and Germany: American Concerns	Today, in one of history's great role reversals, Tokyo and Bonn have become Washingtons fierce trading rivals and also its primary bankers. In the 1990s economic pressures are likely to be the major factor reshaping ties among the three nations. Tokyo and Bonn could present the U.S. with almost intractable problems deriving from their domestic drives, which in some cases their interests could converse in opposition to America's needs. This article examines how the U.S. should deal with the new economic reality.	Foreign Affairs Council on Foreign Relations, Inc. 58 East 68th Street New York, NY 10021
International Challenge for American Banking	This study focuses on three public policy issues that concern the U.S. and all countries with whom it maintains active economic and financial relationships. To this end, the study examines three questions. First, should limits be imposed on foreign ownership of U.S. financial institutions? Two, How "level" is the international financial playing field? Three, what is the role of government in "guiding" private bankers doing business abroad?	Center for the Study of American Business Washington University Campus Box 1208 One Brookings Drive St. Louis, MO 63130 Formal Publication, Number 94
Securities Operator: A Guide to Operations And Information Systems In The Securities Industry	The explosion in both domestic and international trading of securities has centered attention on the need to develop modern systems for more efficient and effective operations worldwide. This book ties together the much-needed information on the "back office" and the "data processing" functions of the U.S. and international securities industries. The book provides specific information on both domestic and international trading support, with a contemporary and comprehensive analysis of securities processing and technology.	New York Institute of Finance Publishing & Professional Information Services 70 Pine Street New York, NY 10270-0003 212/344-2900

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SECURITIES INDUSTRY ASSOCIATION

TRENDS

An Analysis of Emerging Trends in the Securities Industry

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Crisis Brewing: The Precarious Position of State Governments

Highlights

1. New York State and City are wrestling with budgetary dilemmas, a conditioned shared by a growing number of states and localities. With economic growth projected to slow in 1990 and legislators' resistance to spending restraint, state and local taxes will become an increasing burden on business and individuals.

2. Revenues of government -- federal, state and local, while matching the increase in nominal GNP in the period 1978-88, clearly surpassed the 81% increase in inflation and, more importantly the 29% rise in real GNP.

3. State and local governments enjoyed hefty surpluses overall in recent years. However, fiscal conditions vary widely on an individual state basis. The National Conference of State Legislatures predicts more than half the states will face serious budget problems in 1990.

4. New York is a high cost producer of public goods and services. The average tax take for state and localities is $115.62 per $1,000 of income -- New York's at $163.73 is more than 40% above the national average. Neighboring states -- Massachusetts, Connecticut and New Jersey -- are not exactly tax havens, with tax burdens all above the median in terms of per dollar of income.

5. On a cumulative basis, New York's general fund budget has increased almost 35% from fiscal 1985-86 to 1990-91 (proposed), while inflation has increased by 21.8%. The state has maintained its spending pattern through a pattern of perpetual deficits.

6. With some states and localities unable to hold spending even in-line with inflation, policymakers must focus on how large the public sector should really be.

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Crisis Brewing:
The Precarious Position of State Governments

Introduction

In January, Governor Cuomo announced his budget plan for the 1990 fiscal year which, although billed as "austere", would raise total state spending to $51 billion, or about 9.3% above the level of fiscal 1989. In comparison, President Bush's budget for fiscal 1991 projects a spending increase of just 3%. New York's executive budget makes provision to close a projected deficit of over $2 billion through almost $1 billion in increased or new taxes and other measures. For the securities industry, prominent among these measures is the cancellation of the final phase of the individual income tax cut, a 1/2% gross receipts tax, a 6% excise tax on out-of-state telecommunications, and a 2% tax on the net income of "S" corporations. The executive budget projected a $700 million deficit going into the final quarter of the current fiscal year.

New York State's budget difficulties are exacerbated at the City level. In presenting the financial plan for New York City in early February, Mayor Dinkins called for a budget of about $27.8 billion in fiscal year 1991, an increase of around 5% from the current fiscal year. The combined budget gap for 1990 and 1991 was estimated at $1.3 billion. About $550 million in new taxes are proposed to close this deficit, including a 3-year 7.5% surcharge on the personal income tax estimated to raise $200 million in revenues. The City is also seeking permission from the state to tax interstate and international telecommunications similar to the state's proposal.

New York State and City are not alone in their budgetary dilemmas: Connecticut, $150 million projected deficit; Maine, $210 million; Massachusetts, $500 million; New Jersey, $550 million. The list keeps growing, as do the projected deficits. While sustained deficits are the exclusive domain of the federal government, the budget gaps cropping up at the state and local level and the creative array of taxes devised to close them are drawing, and should draw, increased attention from taxpayers and others. With economic growth projected to slow in 1990 and legislators' resistance to spending restraint, state and local taxes will become an increasing burden on business and individuals. Federal tax initiatives, which dominated the scene in the 1980s, may be overshadowed by tax proposals put forth by states and localities in the 1990s. Indeed, federal tax changes may become "tame" in comparison to state and local tax initiatives.

This issue of Trends represents the views of the authors, J. Schaefer and C. Hildebrandt, and not necessarily the views of SIA.

The Big Picture

Government -- federal, state and local -- was fueled by about $1.7 trillion in total revenues in 1987-88. This divides up to $7,226.74 per person in the U.S. or $471.42 per $1,000 of personal income (includes other charges as well as social security). In other words, for every dollar of income, the government in its broadest form is a "partner", taking almost half of an individual's income. If social security related and other revenues are excluded, the bite drops to $4,061.22 per capita or $264.99 per $1,000 of income. Over the 10-year period 1978-88, federal revenues increased 120%, with the individual tax component almost keeping step with this pace. Social security contributions soared 170%. State and local receipts rose 112% during the period, but the individual tax component jumped 162%. Revenues of all governmental levels, while matching the increase in nominal GNP, clearly surpassed the 81% increase in inflation and, more importantly, the 29% rise in real GNP.

With its power to operate in deficit, the federal government did a much "better" job of increasing spending than states and localities which, nevertheless, did their fair share. Federal expenditures grew 138% in 1978-88, considerably more than receipts, and the stubborn federal deficit stands as testimony to this overspending. States and localities also increased spending at a faster rate than receipt growth in the past 10 years, 116% versus 112%. However, although the rate of spending increased more than the growth in receipts, state and local governments combined still enjoyed surpluses in recent years.1/ This surplus reached a record high of $65.1 billion in 1985 but has subsequently declined in every year to an estimated $45.0 billion in 1989.

The overall surplus for state and localities, while comforting, cannot be viewed as an overall indicator of the financial health of state and local governments. Fiscal conditions vary widely on an individual state and regional basis. Many states are now scrambling to resolve their deficits and are dipping into reserves and "rainy day" funds, in addition to pushing for increased taxes.

The Handwriting on the Wall

A summary of tax actions of states in fiscal 1989, one that started with a rosier scenario than 1990, puts the handwriting on the wall. Spending out of total state general funds (the main operating fund of the state, with income derived from state imposed taxes) is estimated to have increased 7.2%, somewhat more than the 6.6% reported for fiscal 1988. Moreover, the rate of spending increase was clearly more than the projected revenue growth of 6.5%. It is not surprising that of the major state tax changes in 1989, tax increases swamped tax decreases.

Forty-two states made notable tax changes: 30 states enacted net tax increases, 11 states made net decreases, and one state implemented a revenue-neutral change.2/ The end result was a net tax increase of $3.5 billion, or $4.7 billion without the inclusion of New York's $1.2 billion tax adjustment to the broadened federal tax base resulting from the Revenue Act of 1986. A $4.7 billion increase equals the previous largest rise of the decade in 1983.

1/Based on national income and product accounts, Department of Commerce, Bureau of Economic Analysis.

2/State tax statistics in this section are drawn from State Budget Actions in 1989, National Conference of State Legislatures, August 1989 preliminary survey.

Every type of tax was used to maneuver states into fiscally "responsible" positions. Excise taxes were the most common, with 23 states raising motor fuel taxes, 13 increasing cigarette taxes, and 7 boosting alcoholic beverage taxes. There were 6 broad increases in personal income taxes. Five states pushed up their sales tax by increasing the rate and broadening the base, while 9 others increased the sales tax by expanding the base only. Five states broadly increased corporate income taxes. New York's corporate tax package was designed to raise $188 million. Included in the package was a restrictive provision on the use of the dividends received deduction by corporations which impacted mainly securities firms. Also, unprecedented limitations were legislated on merger and acquisition activity through tax penalties that seem to serve the interests of entrenched corporate management.

Of the tax decreases, the main tax cuts were broad personal income tax reductions in six states, including New York. The New York reduction was the third phase of the state's 1987 tax reform which was to return to taxpayers more than $11 billion resulting largely from the federal tax reform "windfall". The Tax Act of 1986 broadened the tax base significantly and, without rate adjustments by state and local governments, would have resulted in a windfall.

Overall, the year-end balances of states, which serves as a safety hedge of sorts, for fiscal year 1989 was significant, with preliminary estimates placing it at one of the highest levels of the 1980s, about 4%-5% of total expenditures. However, the major reason that state fiscal conditions improved in the past year was the stronger-than-expected performance of the national economy rather than prudent state fiscal policies. In retrospect, the economic assumptions undergirding state budgets were too conservative.

So too, the fiscal predicaments of several states drew much attention. In particular, the northeastern states were the first group to experience serious revenue shortfalls. Massachusetts took the lead and now has the dubious distinction of a triple-B credit rating. The National Conference of State Legislatures predicts more than half the states will face serious budget problems in 1990. However, tax increases may be delayed until fiscal 1991 rather than 1990, given the many tax increases enacted in 1989 and the 1990 general elections, which usually temper ambitious tax increases.

State & Local Taxes

Every taxpayer likes to complain about the weight of his or her tax burden. At the state and local level, that burden can be measured in two ways -- per dollar of personal income and per capita. Taxes per dollar of personal income is the more informative, given that income is considered the "best" indicator of ability to pay. In general, northeastern states tend to have above-average tax burdens relative to income or "ability to pay" as compared to the rest of the country.

For every $1,000 of personal income, New York has a $163.73 tax bite, the highest in the region and about third in a ranking of the 50 states and the District of Columbia.3/ Only Alaska and the District of Columbia are ranked higher. However, Alaska and several other high ranking states generally have a low resident tax burden because most of their taxes are "exported" to others through energy companies. All

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3/ A state's tax system is analyzed in conjunction with the local in order to derive an overview of the total state tax system. Hence, reference to New York includes New York City and other localities. Rankings are based on 1987-88.

Table I

State & Local Revenue
Per $1,000 of Personal Income
1987-88

	Total Revenue	Total Tax Revenue	Property Taxes	Sales & Gross Receipts	Income Taxes
U.S. Average	$234.73	$115.62	$35.09	$41.47	$29.75
	CT 180.69	107.98	43.13	42.60	13.96
	MA 199.62	113.50	36.29	26.42	45.08
	NJ 199.41	109.62	46.13	33.06	23.95
	NY 301.99	163.73	47.98	44.20	61.60
HIGH	AK 730.98	AK 197.25	WY 70.37	HA 79.28	NY 61.60
LOW	NH 162.56	NH 86.19	AL 11.13	OR 10.57	4* 0

Source: Government Finances in 1987-1988, U.S. Department of Commerce, Bureau of the Census.

* Four states, Nevada, Texas, Washington and Wyoming, collect no revenue from income taxes.

states generally have some ability to export taxes, but the greatest ability rests with the major energy-producing states and small states with large tourism such as Hawaii and Nevada.[4]

The average tax take for state and localities is $115.62 per $1,000 of income (See Table I). New York's $163.73 take is more than 40% above the national average. Helping New York gain its prominent tax burden position is the highest income tax per $1,000 among the 50 states, $61.60 -- more than twice the national average. Across the board, in fact, New York beats the national average and its neighbors. This is not great news from a competitive viewpoint, analogous in the private sector to being the highest cost producer. Not that New York's neighboring states are exactly tax havens. Massachusetts, Connecticut, and New Jersey, all are above the median in terms of tax burden per dollar of income.

A per capita ranking of state and local tax revenues catapults New York and its neighbors into the top 7 states in terms of tax burdens (See Table II). Claiming third, New York's per capita tax soars 65% above the national average of $1,772.43 and the region as a whole is not far behind. A combination of hefty taxes elevates the region. For example, Massachusetts' revenues from general sales tax collections fall below the median, but the tax burden on income gives that state the less-than-desirous position of being right behind New York.

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[4] "Interstate Tax Comparisons and How They Changed Over Time" by Steven Gold and Judy Zelio, Tax Notes, 3/20/89.

Table II

State & Local Revenue
Ranked by Per Capita
1987-88

	Total Revenue	Total Tax Revenue	Property Taxes	Income Taxes	General Sales Taxes
U.S. Average	$3,598	$1,772	$538	$ 456	$428
	NY 3 5,412	NY 3 2,934	NJ 4 933	NY 2 1,104	CT 4 614
	NJ 8 4,033	CT 4 2,281	CT 6 911	MA 3 858	NY 7 570
	CT 12 3,817	NJ 6 2,217	NY 7 860	NJ 16 484	NJ 21 406
	MA 14 3,799	MA 7 2,160	MA 12 691	CT 36 295	MA 34 343

Source: Government Finances in 1987-88, U.S. Department of Commerce, Bureau of the Census.

Measured over time, state and local tax revenues escalated in the 1970-78 period by about 6.6% per $100 of income (See Table III). Regionally, increases in all four states outpaced the national average, with Massachusetts collecting some 22.3% more per dollar of income by the end of the period. The trend was reversed in 1978-87, as state and local tax revenues dropped relative to income by 5.1%. However, revenues in New York and New Jersey did not decline by as much as the national trend, while Connecticut's revenues relative to income continued to increase. Regionally, revenues generally swelled by significantly more than the national average in 1970-78 and decreased by less in 1978-87, with the exception of Massachusetts. Consequently, over the 1970-87 period, the region generally saw double-digit increases in tax revenues not only in absolute amounts but, even more troublesome, per dollar of income. The tax take for New York and its neighbors grew notably, in sharp contrast to the U.S. average of 1.2%.

Where It Goes

The national average state and local per capita expenditure is $3,365.09. The high regional tax burden, however, has supported well-above average expenditures. New York's per capita spending is $5,025.91, almost 50% above the national average of $3,365.09 and considerably above regional spending (See Table IV). Massachusetts, New Jersey and Connecticut, although above the median, are considerably closer to it than New York. For example, although Massachusetts ranks fifth in terms of per capita spending, that spending is only 17% above the national average.

New York ranks high in targeting resources for education and public welfare as does the region generally. New York's outlays for elementary and secondary

Table III

State & Local Tax Revenue
Percent Change Per $100 of Personal Income

	1970-78	1978-87	1970-87
U.S. Average	6.6%	-5.1%	1.2%
New York	13.4	-0.3	13.1
New Jersey	18.1	-4.4	12.9
Connecticut	7.9	3.3	11.4
Massachusetts	22.3	-17.5	0.9

Source: "Interstate Tax Comparisons and How They Have Changed Over Time", Steven Gold and Judy Zelio, Tax Notes, 3/20/89.

education, $933.99 per capita, run some 35% above the national average and for public welfare, double the average. However, as anyone driving through the City or State may suspect, highway spending is a relatively low priority.

Focus on New York State

New York has many claims to fame. It is the second most populated state and one of relative wealth. However, there are a host of problems to deal with -- the homeless, a large AIDS population, drugs, education, New York City, etc. Not to mention a high cost of living. How the state has dealt with these problems in terms of resource dedication is depicted in Table V.

As explained in the Public Policy Institute of New York State's recent publication, The 1990 Taxpayers' Guide, wading through the budget is, indeed, a complex and difficult task.[5] Focusing on New York's general fund or cash budget (main state operating budget) years shows an increase of almost 35%from fiscal 1985-86 to 1990-91 (projected). While this budget is presented as the executive budget, it does not include all state spending, omitting both federal funds and special fee programs. It is estimated that $1.9 billion in fee-related spending has been shifted off budget in the past four years. (A "trick" possibly picked up from Big Brother.)

The all funds budget incorporates all state spending of funds from all sources. Considerably larger than the general budget, the all funds budget has increased by almost 48% over the period. Both budgets have, in fact, increased sharply faster than inflation, 21.8% (cumulative), over the fiscal 1985-91 period. (See Chart I).

Education and health and welfare are the state's top priorities, with spending increasing by 106% and 156%, respectively, from 1980 to 1990 (proposed). In fiscal 1990-91, health and welfare spending of $19.3 billion is proposed and education spending, $16.2 billion, making these two sectors over 30% each of total spending. Public protection, however, received the largest increase in funds of the delineated priorities over the period, 333%, and now encompasses some 5% of total state

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[5] Data and commentary in this section are based largely on this excellent publication.

Table IV

State & Local Expenditures
Ranked Per Capita
1987-88

	Total Expend.	Elemen. & Secondary Education	Public Welfare	Highways	Capital Outlay [1]
U.S. Average	**$3,365**	**$690**	**$362**	**$226**	**$364**
	NY 3 5,026	NY 3 934	NY 2 725	CT 12 303	NY 15 413
	MA 5 3,946	NJ 5 828	MA 4 578	NJ 17 279	NJ 19 387
	NJ 9 3,707	CT 11 774	CT 12 405	NY 30 221	CT 20 386
	CT 11 3,585	MA 24 683	NJ 14 386	MA 48 181	MA 30 341

Source: Government Finances in 1987-88, U.S. Department of Commerce, Bureau of the Census.

[1] Direct expenditure for contract or force account construction of buildings, roads and other improvements, for purchase of equipment, land, and existing structures and for payments on capital leases. Includes amounts for additions, replacements and major alterations to fixed works and structures. However, expenditure for repairs to such works and structures is classified elsewhere.

spending. With the exception of general purpose aid to localities -- the result of which can be seen in New York City's budget situation, all funds spending in 1980 to 1990 for major programs skyrocketed in comparison to inflation for the state and local sector, 64%.

How the state has fared in recent years in maintaining its spending pattern is summed up in a pattern of perpetual deficits. The fiscal 1988-89 deficit was closed by funds from the special tax windfall account and borrowing. The projected fiscal 1989-90 deficit was to be closed by $900 million in increased taxes and holding spending growth to 4.9%. Nevertheless, fiscal 1989-90 has missed the mark and is projected to end with a $350 million deficit because of $312 million more in spending and a larger than expected deficit in the prior year, requiring dipping into the current year's revenues.

Living close to the edge -- or spending every dollar of projected revenues -- makes for difficult budgeting particularly in times of economic uncertainty. However, "revenue shortfall" is heard more frequently than spending overrun. Particularly for 1989-90, revenue shortfall is carrying the blame. Some revenue sources are down from projections, but not all. Personal income tax collections are estimated at $15.8 billion - - $504 million more than originally projected.[6] Business taxes are projected to

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[6] We understand that January 1990 income tax collections are down sharply from 1989, as the general economy weakens and Wall Street's decline is finally reflected in tax revenues.

Table V

New York State Spending Priorities

All funds budget, $ millions

Priority	FY 1980-81	FY 1990-91 Proposed	% Increase
Public protection	$ 641	$ 2,775	333%
Health & welfare	7,552	19,323	156%
Mental health	1,865	4,399	136%
Education	7,838	16,181	106%
Parks and environmental affairs	525	1,571	199%
Housing and economic development	437	943	116%
Transportation	2,098	4,608	120%
General purpose aid to localities	963	1,152	20%
General government, other miscellaneous	285	1,414	396%
Aggregate inflation rate (state & local sector)			64%

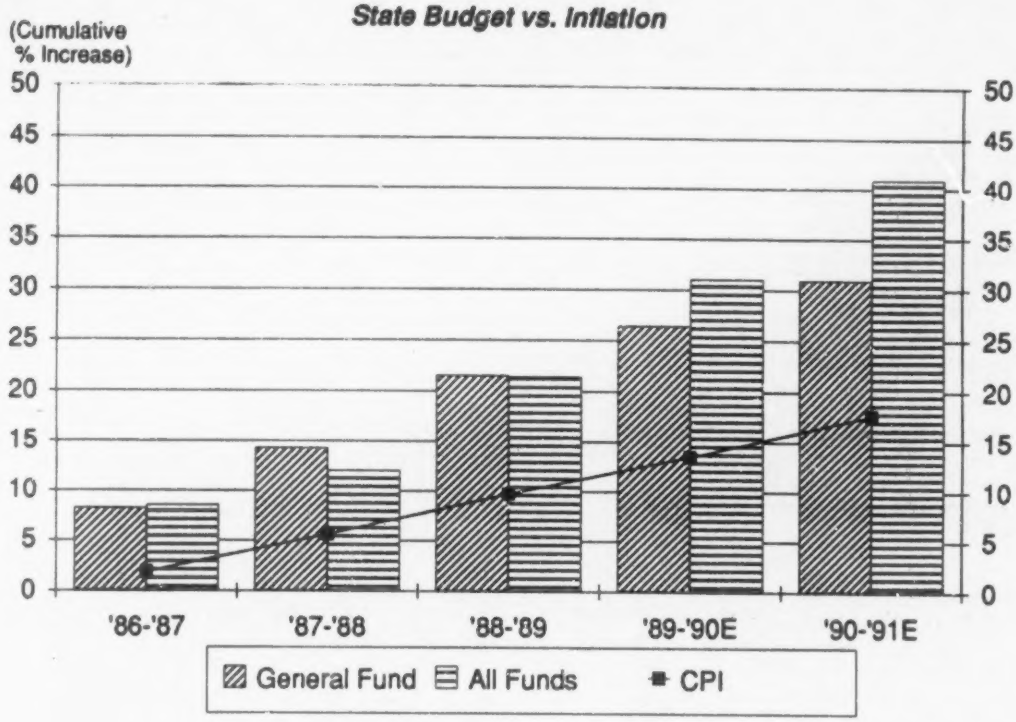
Source: The 1990 Taxpayers' Guide, The Public Policy Institute of New York State, Inc., Albany, New York, January 1990.

estate gains taxes and overestimation of add-on taxes enacted last year. Although some revenues did not "live up" to expectations, the bottom line is: revenue forecasting errors would not have resulted in a deficit, if spending had been held to the level originally proposed.

Revenue forecasting is a difficult art, with mistakes resulting in large errors in projected versus actual revenues. For example, if personal income grows in 1990 by 6.2% (forecast used by the State Budget Division until just before the budget was introduced), instead of the 5.5% currently forecast in the executive budget, the state would collect about $200 million more in personal income taxes -- without canceling the personal income tax cut.

Business Taxes

For a number of reasons, New York State has experienced a decline in corporate tax collections(Article 9-A) since 1978-79, one that has been more acute in recent years. In fiscal 1981, New York collected $1.09 billion from 415,000 9-A corporations. By fiscal 1989, those collections had risen to $1.42 billion from 225,000 companies. In other words, 30% more tax revenue was collected from 46% less companies. The difference in the number of reporting companies is explained by a shift to Subchapter S corporate status by more than 200,000 companies.



Note: Budget based on fiscal year; CPI on an annual basis.
All estimates from State Budget, 1990-91.

Moreover, despite a corporate tax cut in 1987, between 1981 and 1989, the average corporate tax payment increased to $6,311 from $2,397 per company. The business share of all state taxes is approaching 21%. In terms of corporate tax burden to corporate net income, New York ranks second among all states and about twice the national average. Only Massachusetts has a heavier tax burden. Nevertheless, a hefty package of tax increases for business are included in the Governor's budget for 1990-91. New business taxes total at least an estimated $382 million, excluding the estimated $135 million from the 6% telecommunications tax that will impact mainly the business community.

Last year's tax package and this year's proposed business taxes fall hard on the financial services industry, especially the securities industry. As New York's economy has shifted from goods producing to service based, the services sector has accounted for an increasing share of 9-A corporate taxes. Wall Street plays a dominant role in the services sector which is composed of finance, insurance, real estate and other service industries. In corporate fiscal year 1977-78, the goods-producing sector paid over 55% of total NY corporate tax collections and the service sector, less than 20%.[7] In 1985-86, the service sector's share approached 40% or twice as much in relative terms. With Wall Street a major player in the services sector, there are important implications for forecasting 9-A revenues -- given the profit volatility of the securities industry. (See Chart II). Moreover, continual targeting of a large and vital component of the state's and city's economies for tax increases is no way to remain competitive. Given the current state of the industry -- contraction and low profitability,

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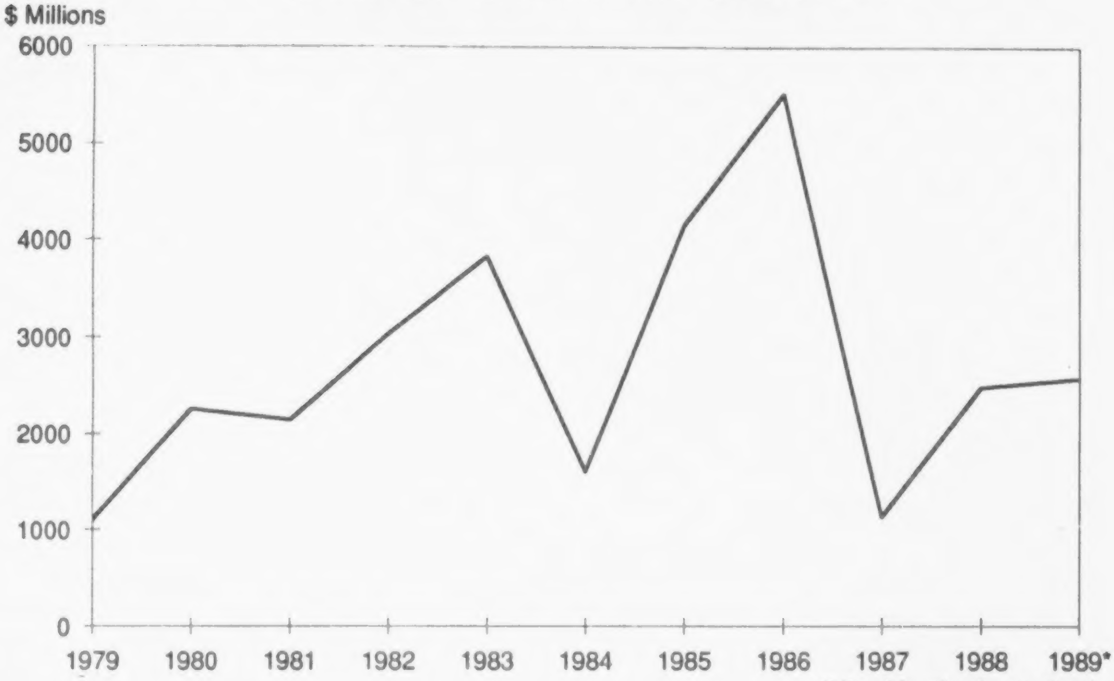
[7] New York's Business Tax Decline, Discussion Paper, Department of Taxation and Finance, November 1989.

SECURITIES INDUSTRY PRE-TAX PROFITS



*Nine Months Annualized

it is certainly questionable public policy to be raising taxes since the securities industry has shown the ability to relocate in order to reduce costs.[8]

Conclusion

The 1990s are shaping up to be one of fiscal stress for states and localities -- it already has started. State spending in the 1980s was increased to meet the needs of education, public welfare, etc. But more has not necessarily proved to be better. More money for additional and existing programs does not necessarily translate to improved services. The quality and effectiveness of spending programs may, indeed, be difficult to measure but surely some attempt is necessary given the rapid run up in spending in the 1980s.

Gramm-Rudman, although far from perfect, has at least set deficit targets that limit increases in federal spending. Several states and localities have adopted tax expenditure caps. With some state and localities unable to hold spending even in-line with inflation, policymakers must start focusing on how large the public sector should really be.

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[8] In a study released in 1985, it was estimated that the securities industry accounted for 4% of NYC's employment in 1983 and each securities industry job supported three additional jobs in other sectors. Until 4Q87, the securities industry's importance to NYC and NYS was growing rapidly. For New York City, it has been estimated that the securities industry accounted for more than one third of private sector job growth in the 10 years prior to the crash.

State and local taxes have more than kept pace with the escalation in personal income in recent years. For various reasons, voters have been willing to see the state and local sector expand in step with personal income. But, apparently some states, including New York, allowed taxes to rise much faster than income. Taxpayer resentment is becoming a widespread reality. States such as Connecticut, New Jersey, and New York are in this predicament.

There are many signs that national economic growth is turning sluggish. At the very least, the Northeast region is lagging economically and several important sectors are depressed. Clearly, the real estate and securities markets have suffered dramatic slowdowns, particularly in activity or transactions. The New York Times recently reported that sales of residential homes plunged from 224,000 in 1987 to 187,000 in 1989, or 16.5% in just two years. For the first time in many years, "must sell" homeowners are experiencing losses. The slide in home sales is even steeper than the 12% drop in average daily volume on the NYSE from 1987 to 1989.

When budgets are now introduced calling for increases of over 9% in total spending as in New York, taxpayer frustration can be expected to follow. Government cannot expect the private sector to "sit quietly" and accept increases in tax rates or expanded tax bases. Double-digit growth in taxes relative to personal income over almost 20 years is simply unacceptable to most taxpayers.

New York is a high tax state. That is a problem which should be of prime concern to policymakers. In the private sector, the high cost producer eventually suffers the consequences of contraction and disruption, if not eventual liquidation. New York is a high cost producer, and problems cannot be resolved by raising taxes (costs) further.

The securities industry enjoyed some strong years in the 1980s. Nevertheless, over 45,000 industry jobs have been lost since 3Q87, almost 17% of the pre-October 1987 labor force. Firms have gone out of business and top management has dramatically changed in many organizations. State policymakers face problems of equal magnitude, with difficult choices needed on spending priorities and the allocation of scarce resources. Increased taxes are a poor public policy choice in periods of economic stress when vital sectors of the New York economy are experiencing a business downturn. The ultimate consequences for state and city leaders is an erosion of the future tax base, even if such events occur under another "watch". The time has come for New York's leaders to wrestle with and resolve the problems of being a high cost producer of public goods and services.

Carolyn Hildebrandt
Assistant Vice President &
Director of Macroeconomic
Studies

Jeffrey M. Schaefer
Senior Vice President &
Director of Research

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
Economic Report of the President	Annual summary of the state of the economy and future prospects. This year's report focuses on the design of fiscal, monetary and financial policies, human resources in the 1990s and growth and market reform in the global economy. Large historical statistical section relating to national income, employment and production.	Superintendent of Documents U.S. Government Printing Office Washington, D.C. 20402
"Cash Burning a Hole in Their Pockets?"	Results of recent Barron's survey of more than 3 dozen equity managers. By more than 2-to-1, institutional money managers believe the bull market is alive and reasonably well, but the consensus has the Dow marking time for the next six months. In response to their cautionary impulses, these money managers have increased their cash levels sharply. Overall, the median level has gone from around 7% six months ago to 13% now. Prediction: Dow will bottom out at 2200 before resuming its climb.	Barron's March 5, 1990
"Firms still bank on LBOs"	With the latest batch of troubled LBOs, some market watchers are predicting the end of the LBO era. But the players -- investment and commercial bankers, LBO boutiques, merchant bankers, lawyers, consultants and others -- say the market is giving them a breather. Time to rethink the type of deals done. Clearly, in the future, there will be more equity and less debt, especially junk bond financing. Directory of LBO industry advisers and bankers includes principals, key deals, and description of what the fund does.	Pensions & Investments March 5, 1990
"Still toe-to-toe: Banks and nonbanks at the end of the '80s"	Reviews competition in consumer lending, auto financing, commercial lending and other areas. Market shares, loan volumes, and ROIs suggest that banks are competing skillfully and successfully with the competition. At the very least, banks are holding their own against the competition. Authors conclude: while banks may be hampered somewhat in the future by "past mistakes" -- LDC and real estate lending, broaden powers, especially in insurance brokerage and underwriting, should see the banking industry running well ahead of nonbanks.	Economic Perspectives Federal Reserve Bank of Chicago January/February 1990

Item	Description	Source
"Drexel on the rocks"	Brief commentary on financing in the 1980s from the British perspective. The bursting of Drexel's bubble, along with the collapse in the junk-bond market that chiefly prompted it, will be good for America. But it is wrong to assume that everything to do with Drexel or finance in the 1980s was evil. If America is to regain its competitiveness in the 1990s, there are at least 3 things it must not do: close its markets against the Japanese, protect its managers from takeover, and turn against money-making. Too cheery a wake for Drexel risks two of these.	The Economist February 17-23
"Dealing With the New Europe"	Special international issue focusing on the Eastern Block countries and the implications of change for Western businessmen and bankers. Also, ranking of the largest 1,000 foreign nonfinancial companies by sales and grouped by country of incorporation. Over one-third -- 373 to be exact -- of the largest 1,000 foreign companies based on sales, and 9 of the top 10, are Japanese firms. Even if American companies were included, only General Motors would make the top five.	Financial World March 6, 1990
"The Lean Decade"	Issue dedicated to looking ahead in four key areas of financial services -- money management, banking, Wall Street, and insurance, as well as what regulatory and technological changes may be in the cards. Also, 18th annual Pensions Directory, listing corporate employee-benefit funds, public funds, and money managers. Assets under management for this group total just short of $1.5 trillion, or 22% higher than last year.	Institutional Directory January 1990

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SIA SECURITIES INDUSTRY ASSOCIATION

TRENDS

An Analysis of Emerging Trends in the Securities Industry
Produced by the SIA Research Department

Vol. XVI, No. 3 April 30, 1990

STRUCTURING FOR SUCCESS - TRENDS FOR THE 1990s

Highlights of SIA's 1990 Trends Conference
March 1, 1990, New York Hilton

HARRISON J. GOLDIN

Principal, Goldin Associates
Founder & Chairman Emeritus, Council of Institutional Investors
Former City Comptroller, New York City

"The Buy Side's View - Customer Demands for the 1990s"

Institutional investors in the 1990s will be emphasizing foreign investments, private placements, real estate opportunities, oil and gas production, opportunities targeted locally to promote affordable housing and small business, and companies with longer time horizons in their business strategies.

The most significant development today is the keen interest of institutional investors in foreign investment. Pension funds are raising their international targets from 10% to as much as 20% of their assets. That trend will not only gather strength in 1990, but remain strong throughout the Nineties.

Public pension funds are somewhat behind their private and foundation counterparts in exploiting international investment opportunities. But the decade will see a surge of public pension asset commitments to foreign stocks and bonds. The bulk of their foreign investments this year and next will be in indices that both spread risk and reduce the need to make selections among individual companies. Nonetheless, not all investments will be in developed countries. Some will be in emerging markets: Argentina, Brazil, Mexico, Taiwan, Thailand, South Korea to mention a few.

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A second category of investments likely to increase significantly is private placements. To an ever greater extent, institutional investors are being asked to buy stock or bond issues not traded publicly. More and more institutional investors are saying yes.

The institutional market for the third category, real estate, is soft at the moment. Pension funds generally are diffident about real estate but that will change. Patient and foresighted institutional investors will consider the weak market a good buying opportunity.

The situation is similar in oil and gas. Depressed prices, a heightened public sensitivity to the environment, and vocal opposition to localized drilling operations have all dampened exploration and production of oil and gas. But the real price of oil and gas is likely to rise in the 1990s while new technology and safeguards will make exploration, production, as well as transportation, environmentally safer. Institutional investors will invest in this opportunity.

A fifth emphasis is likely to be targeted investments. We pioneered this field when I was Comptroller of New York City and saw no problem using public pension funds to promote social objectives, especially affordable housing in NYC, so long as the pension systems received market rates of return on their investments. For instance, mortgages extended by our agents in red-lined and moderate income communities in NYC were pooled into federally guaranteed, high yield Ginnie Maes, $700 million of which were purchased by the city pension funds. That increased liquidity in neighborhoods in which lenders are typically reluctant to invest, providing additional funds for lower and moderate income housing and resulting in new and rehabilitated homes for thousands of New Yorkers.

Finally, institutional interest will likely grow in investments that require a longer time horizon. This is not venture capital for new businesses, but what is now called patient capital - for businesses that have not yet made it big but are at a critical point in their development. These are companies with successful operations that are deliberately plowing significant portions of their profits into research and development and other internal investments. The rationale is that smaller gains now could lead to a commensurately greater return in the future.

STEPHEN L. BROWN

President and Chief Operations Officer
John Hancock Mutual Life Insurance Co.

"***Structuring an Integrated Financial Services Firm***"

A diversification strategy makes good business sense because it improves the likelihood that some lines of business will be profitable when other lines have problems. The cliche about spreading one's eggs among a number of baskets is right. It's also important to move into businesses which build on a corporation's strength and image and put the company in the path of future growth. Of course, growth and profitability aren't necessarily the same.

It isn't enough just to enter new businesses; successful diversification also means significant changes in parent company strategy and culture. A diversification strategy has to be accompanied by some crucial supporting strategies. At Hancock, we clearly said that our strategy for the 1980s was to diversify into other financial services businesses, pursue a market oriented and profit-centered strategy, and pursue a financial strategy which enabled us to track and compare the performance of our insurance and non-insurance businesses on a timely and consistent basis.

.The advantage of being able to compare performance within our financial services complex is that we can make objective decisions about which products and businesses should grow and which ones should diminish.

We defined our organization as having three major markets: retail, investments and pensions, and group. Within these, we refined each of those businesses into product and profit centers with managers accountable for each separate business. We developed a system to compare the performances of very different businesses. An internal system of GAAP accounting was developed, which we were not required to do as a mutual company. This enabled us to compare our overall performance with the new competitors that we faced.

With these tools in place and reporting systems greatly speeded up, we were able to measure current performance and future plans of each business segment against firm-wide goals for financial strength, growth and profitability, and to compare capital requests from each business and determine which offered the firm the most attractive long-term returns.

Recent history has shown that diversification can be very treacherous and involves changes that many companies are not prepared for. Clearly the S&Ls are the worst case, but I'm afraid many of us entered businesses whose pitfalls we didn't understand fully. Whether we survive those pitfalls depends greatly on the size of our investment and the extent to which we take steps to understand the risks of new businesses.

Invariably, we will make mistakes, especially as the business outlook changes. For example, we looked at the numbers on HMOs in 1983 with that business segment returning about 25% a year for as far as the eye could see. Five years later, returns were becoming marginal at best, and projections told us that the future was bleak for all but a few major competitors. We were faced with a choice to either make the very heavy investments required in such a marketplace or to exit the HMO business entirely and move our capital into areas with better returns.

Said this way, there really doesn't seem to be any question that exiting was best. For most of us, deciding to exit a going business is very difficult and a lot of emotion and ego gets involved. Without a structure and a financial discipline to enforce such decisions, the likelihood is that some of those difficult decisions won't be made or will be deferred until it's too late.

After 1987, we clearly had to re-evaluate our brokerage business and decide whether our initial strategy of building from a regional to a national presence still made sense. Tucker Anthony depends heavily on retail business and post-crash there wasn't an awful lot of retail business around. At the same time, we asked ourselves whether pursuit of a national brokerage identity was worth the costs involved or if regional firms with strong research and local identity and presence would offer a better return. We made a strategic shift starting about two years ago, and our brokerage business today is profitable and on the way to meeting its long-term profit goals. Equally important, it's developed a good balance of retail and other businesses.

Our decisions regarding HMOs and our brokerage arm were really quite different - in one case to exit the business, in the other to change strategy. Both resulted from the underlying structure we developed to help make those decisions. Hancock does not enter the 1990s with any guarantees, but I believe that we have given ourselves the best possible chance to succeed.

ROY C. SMITH

Professor of Finance, N.Y.U. Graduate School of Business
Former Partner, Goldman, Sachs & Co.

"Global Banking in the 1990s"

Europe — An economically integrated Europe will be the world's largest single marketplace for goods and services and will attract large amounts of strategic investments by European companies as well as from U.S. and Japanese companies who will move funds away from the U.S. and Japan. The European restructuring will become even larger if non-EEC European countries become members or if Eastern European countries are able to join in some manner.

There was more than $160 billion in mergers involving European corporations last year, half the world's total. The process is still in a very early stage, but it already involves most forms of free market transactions including hostile bids and leverage buyouts. While U.S. M&A has dried-up, European M&A is now the fastest growing sector in global M&A.

A large, single European capital market has begun to emerge. This new intra-European market will reflect the consolidation of previously separate domestic markets with a much more global Eurobond market. Already this single market has the capacity to do about $300 billion worth of long-term financing per year, which is about the same amount per dollar of GNP as we have in the United States.

Competition will greatly increase the efficiency of this capital market to borrowers, and many industrial companies will develop capital market access for the first time. In Europe, the practice has not been for industrial companies to use the capital markets to the same extent as in the U.S. This is changing. Also, European companies will no longer have to arrange their financing in Dollars or Yen, but rather in European currencies or in ECUs.

Competition for financial businesses in Europe will greatly intensify, just as after Big Bang. The traditional house bank relationships - one bank, one company - will have to meet the best prices offered to their clients or lose the business, a condition similar to the introduction of the bought deal in the Eurobond market in 1981 and the introduction of Rule 415 in the U.S. in 1982. Product adaptability, expertise, and marketing will be the key ingredients in competitive success and relationship banking in Europe will become more transactional.

The financial environment in Europe in the 1990s - driven by free competition from players from all over the world and fortified by large existing markets such as foreign exchange, swaps, futures and commodities - could become the world's most competitive source of capital, thereby attracting many of the world's largest and most important borrowers from the capital markets they presently use. The implications for U.S. companies is pretty clear: we can lose some of our corporate business to the European markets if we overlook this new competitive challenge.

Japan — Japanese financial markets are likely to experience substantial deregulation in the 1990s which could, in turn, lead to major changes in the competitive dominance of Japanese banks and brokers. The business of Japanese banks has changed radically in the last few years. Through all the period of excess liquidity in Japan, Japanese companies have paid off most of their debt. So, banks are looking for business other than corporate loans and they're focusing on the securities business. They're prevented from entering the securities business by their own Glass-Steagall: Article 65. But if Glass-Steagall is repealed in the U.S., Japan will likely follow suit. After that occurs, competition in the Japanese securities sector will also become very intense, i.e. the idea of fixed commission rates remaining in a post-Article 65 environment is almost unthinkable. As a result, you may see a Big Bang coming to Japan as well.

United States — The big events affecting our industry in the next few years will be Glass-Stegall and the restrictions on the interstate banking competition. Both represent large changes in the structure of the U.S. banking and investment banking industries, and it puts the banks in a dilemma. They have to decide which of these two sectors to move towards. A few can afford to do both, but not many.

The success of specialized investment firms like KKR may encourage some of the individuals at investment banks to go into smaller, more traditional, more profitable, more flexible businesses that reflect investment banking's earliest days. And we've already seen a proliferation of boutiques starting up.

Banks and investment banks will provide wide-scale global services. Also, this may mean convergence with large organizations already skilled in trading foreign exchange, government bonds and some municipal securities but who perhaps have a better management feel and a better ability to operate on a global basis. In the U.S., we'll also see an increasing role played by foreign firms — both banks and securities firms.

JAMES W. WETZLER

New York State Tax Commissioner

"New Frontier - Growing State & Local Tax Initiatives"

During the 1980s, New York State, along with much of the Northeast, was growing faster than the national economy, to some extent helped by the boom in financial services. When New York and the Northeast have an economic boom, it's different than when California, Florida or the Sun Belt has a boom, because these places attract a lot of people in prosperous times while people don't tend to move into the Northeast very often. Therefore, when our economy booms, people become more fully employed, wages go up, real estate prices go up, etc. That's great for those who already own the real estate or receive the higher wages, but it discourages new people and firms to come in and buy expensive real estate, set up shop, and pay higher wages. The effect of the past boom is to make the State and region less competitive now.

Also, the national savings rate has been going up the last couple of years which has the effect of lowering our sales tax receipts, a significant source of revenue. As a result of the Federal Tax Reform Act, a lot more corporations are using Subchapter S corporations, taxed essentially as partnerships, which has, in turn, reduced our business tax receipts. Also, many corporations are now making more money overseas than they are in the U.S., which is non-taxable in New York.

We've had big cutbacks in federal assistance to New York throughout the 1980s. President Bush speaks about doing something about drugs, about education, and whatever, but he means that the states should do it. He's creating popular expectations on these issues but is not giving states the resources to address them nor is he proposing that Washington take on some of that burden.

We have the rise of a new set of expensive problems, like AIDS and drugs, the solution to which will not improve the quality of life of an ordinary person - it will simply prevent it from getting worse. Addressing these problems may prevent a mugging or whatever, but a mugging that doesn't happen is not noticeable as an improvement to your life.

The net effect is that New York has a significant gap between expenditures and tax revenues. At the same time, New York is competing economically with other states and countries, and in order to prosper, we need to be an attractive place for people to live and do business in. For that to happen, the tax burden has to be in some balance with the level of public services that people see they're getting, and their quality of life.

The competitiveness issue is not just in attracting firms to come to New York, but keeping those here from moving out. We're cognizant of the mobility of the financial services business. New York discovered mobility in the 1970s with the big exodus of the manufacturing sector. As a result, the tax system was changed to favor manufacturing.

We're now beginning to realize that a similar problem exists for service businesses but policies have not yet adjusted to accommodate that perception. We have not been entirely inactive about this and have done some things including tax reforms for personal income, corporate franchises, banks, trucking, gasoline, diesel fuel, etc.

Nationally, a lot of things are happening in state and local taxation that are of interest to the securities industry. One issue is apportionment - technical tax considerations of how to apportion a multi-state or multi-national business's income to a particular state. Also, how much contact does a business have to have with a state in order for that state to be able to start taxing it? Typically, income from a service business is apportioned to the state where the services are performed. There is a movement afoot, however, to apportion income from a service business to the state where the customer is located. A number of states, typically the states that don't have financial services businesses, are beginning to adopt this approach - they basically want to raid our tax base. This is being promoted by the Multi-State Tax Commission, which is a compact of most of the western states.

Another area is sales taxes which currently apply mainly to goods. As the economy grows, services tend to grow larger as a percentage of people's spending. In a number of states, there's a trend towards extending sales tax to services. Another trend in many states is for more aggressive tax enforcement. You're going to be visited by more auditors from more states as they beef up tax enforcement efforts.

One serious problem in New York is that state tax is not the only tax you're dealing with. There is a New York City Corporate Tax, there is an MTA surcharge, the combined burden of which can be very, very high - up around 18.4%.

We want to help, but the problem is we have to understand things before we can help. The securities industry must come up and tell us — the Budget Division, the Legislature, the Governor, and the Tax Department — what your major concerns are.

RICHARD FURNISS

Vice President, Towers, Perrin, Forster & Crosby

"Changing Compensation Practices for the 1990s"

Wall Street is intensely dependent on individuals. The securities business requires people to do things by themselves which puts a great deal of emphasis on keeping key producers. There is a valid fear of losing them, stoked by the individual who can always produce a string of offers, many quite real.

Salaries are kept low, because we want to keep our fixed costs down, while the bulk of compensation is dependent on performance: no performance, no pay - a great concept. On Wall Street, firm profits were shared among the professionals. When firms were enormously profitable, often from a small number of businesses, everybody in the professional ranks shared in the pie, often in extreme proportions to the total profit. This is very unusual in the world of compensation, a holdover of the partnership tradition, and does not serve the shareholders.

These incentive plans are paid out in two ways. One is highly discretionary - 100% judgment checks, with very vague measures of performance or goals, which arrive in mysterious ways but are large enough so that it doesn't bother anybody. Everybody who doesn't get paid this way is paid on a fixed, very rigid formula characterized by a sales commission, often with nothing to do with profit but driven by volume or revenue.

So you've got a tremendous component of cost driven by a very unsophisticated and almost unmanageable system - an unstable situation. It worked when firms were awash in money but things have changed and it looks like they've changed permanently. Compensation systems will also have to change.

Business segment profitability will no longer be cyclical, some will be permanently higher or lower. Therefore, no longer can everyone be compensated equally on the basis it will balance out over the years. You have now moved into capital intensive businesses which isn't purely brains, it's putting the firm's capital at risk. Revenue is much less relevant to profit and therefore compensation will have to be more relevant to the bottom line than the top line.

Producers continue to expect high rewards but profits are inadequate to pay both the bonuses and the shareholders. So far, the shareholders have suffered. If the shareholders are also the employees, then it doesn't matter. If the shareholders are the public or some firm that's acquired an investment bank, then you have an unstable situation.

Also, variable pay has become a fixed cost. Securities firms' financial statements show normal fixed costs — salary, rent, interest, etc. — but then you'll also see bonus accruals listed there whether or not there is a profit. Shareholders will say, wait a minute, how come you have bonus accruals when you've got a loss here? The rest of the world doesn't do it that way, they do bonuses after profits. That isn't how it works in Wall Street because you have to pay bonuses to keep people. If I were a shareholder, I'd say that's not the way you're going to do it in the future.

You do have to keep good people, however, so what will happen? Pay for performance - that's the secret. Pay for performance requires management decisions that are hard to make. It will require changes in the way you measure profit. It will require you to keep different sets of books. It'll require you to combine functions that haven't been combined before. It'll even require you to measure customer profitability. The notion of selling a customer something cheap because he's going to buy another product on which you make a great profit is a fallacy that's lead all kinds of companies into Chapter 11, because customers have gotten smart. They'll buy some products from you cheap and they'll buy the rest of their products from somebody else cheap.

So somewhere you've got to revise your system to pay people for generating profit, not revenue. Differentiation of pay is the only way to resolve the dilemma of losing good people. The truth of the matter is that only some people are good. And though these people will continue to move around, that doesn't mean that you've got to pay everybody. What it means is that you've got to pay the producers.

Senior level pay will be based on firm results. As someone moves up the hierarchy in a particular department or function, the less he'll be compensated for results of that function and the more he'll receive based on firm-wide results. There'll be more equity based plans and we've seen a rash of them this year driven by two reasons. One is the classic reason of spreading ownership among employees to make them feel and act like owners. The second reason is the cash isn't there to pay the bonuses that were expected, so stock was used instead.

JOANNE M. HILL

First Vice President, Capital Markets, PaineWebber Inc.

"Trading Technologies for the 1990s"

Technology combined with information and trading vehicles brings market power. Information in the investment business is power. Technology shifts the power balance in the financial marketplace because it allows greater quantities of information to be processed much faster.

Technology is not free and it has definite economies of scale. This means that larger players, who some say already have an advantage because of their size, can also gain advantage by tapping into information more easily and cheaply. Technology doesn't increase trading volume and liquidity, it just shortens the time span for prices to adjust to information. Only investors with easy access to information can expect to profit from being short-term investors.

Investors with more limited access are best served by approaching investments based on their ability to deliver long-term returns in line with their risk profiles. They become strategic asset allocators. It's really not surprising that institutions use asset allocation while, similarly, individual investors shifted to indirect equity vehicles like mutual funds which do this job for them.

Information and technology advantages in stocks or overall portfolios only exist if you have vehicles to capitalize on them. We've always had abilities to respond to stock information but if we have news of a trade deficit or a stronger dollar, without a vehicle to act on this news, is of little value for all U.S. stocks. Now comes index futures and portfolio trading which can apply this technology and act on macro information. These products are indeed the messengers and they've been receiving a lot of bullet holes.

Is it okay for a risk arbitrageur or a mutual fund holding a takeover stock to have tools to react very quickly when news hits the screen but wrong for a portfolio trader to have access to a SuperDOT terminal or a futures market when an economic number alters his asset allocation mix? Is it okay for a trader in stocks to use stop loss techniques that are monitored by some intelligent quote service but wrong for a dynamic hedger to sell stocks or futures when a trigger level is hit?

Currently there are $275 billion of U.S. institutional investments passively managed, of which about $200 billion are in equities - about 20% of all pension equity money. In addition, about 50% of U.S. money going abroad goes into an index fund, i.e. passive management. Passive management has become a dirty word in the securities business. It implies low turnover and low commission rates. But this is an important reason for pension funds, foundations and large investors to choose passive management for their beneficiaries.

To most of us, asset class or program trading is the most scary application of technology. These trades are less frequent than individual stock trades, and they use up a lot of liquidity. But it's very sensible for these people to go where they can find the lowest price which is more often a futures market, not a securities market. This is not because they're benefitting from lower margin requirements because these people are not users of leverage, ERISA limits leverage. It's because the index futures market has 20 times the depth of volume than the NYSE for these trades.

A fundamental or technical asset mixed trade can enter the system from either the futures, options or security markets. If it is large enough, it will be associated with volatility or price change in the same way that a large trade in IBM or Exxon is going to be associated with volatility or price change in that stock. If the trade occurs first in the futures market, this will transmit the impact of the change in the institution's equity exposure through the futures market into the equity market.

Using NYSE program trading data, academics and economists have looked at stock prices following program trades and have determined that these trades carry real information about stock values to the marketplace and not just "noise." If we did not have this type of trading, the information would be absorbed more slowly, through manual stock trades, than what now happens simultaneously through technology.

TIMOTHY F. MCCARTHY

Executive V.P., National Financial - Fidelity Investments

"Clearing Choices for the 1990s"

The October, 1987 earthquake is still sending shock waves through Wall Street. In 1989, four of the seven major clearing firms either went out of business or were substantially reduced in size and influence. Meanwhile, 15% of securities firm clients are no longer in existence. The template for the clearing industry that many of us followed throughout the 1980s is broken and if we expect to succeed in the 1990s, radical adjustments in our attitude and structure are absolutely imperative.

The clearing vendor's role must expand dramatically to help the correspondent client compete. The real threat to our client's long-term success is not just the correspondent clearing firm competition but the local Merrill Lynch or Shearson office. If, for competitive reasons, the correspondent needs to give his investors a consolidated CMA-type statement or needs RR training and sophisticated product marketing support which the Shearson office manager is supplied with from headquarters, the clearing vendor better be ready to supply it so both you and your client can operate and compete.

In the 1990s, there is room for certain vendors to succeed by narrowing their focus, becoming specialists in one or more areas such as clearing asset-backed securities for institutions or executing only non-U.S. securities. However, the dominant clearing players will reach a critical mass in providing a whole raft of services. This integrated package of service will go far beyond what any one vendor today supplies its correspondents. I wouldn't be surprised if a major clearer finally merges with a quote vendor or another information or record-keeping provider. This kind of integration and coordination of services is being demanded of many vendors by their correspondents today.

To succeed, your entire organization must truly be systems literate. The connection between the systems organization and operations must become seemless — systems and operations people will often have had each other's job. Managers will be preoccupied with ripping apart every aspect of their operation and installing system solutions previously thought impossible to insure quick response to their clients' needs. Technological literacy will permeate not only operations and trading, but such areas as client services. The result: decreased labor cost and unparalleled quality.

It is clearly wishful thinking to expect clearing and execution fees to return to the fatter days of the past. Efficient systems are insuring that prices will not rise to any large degree. Surviving vendors will do a lot more product service cost accounting and profitability analysis to determine whether or not they're making money on each client and to get rid of those that are money losers. This better understanding of costs should lead to a lot more price unbundling: higher charges for manually intensive items such as non-book entry or infrequent, low volume trades.

High market volatility, new and expensive systems philosophies, the expanded role of the clearing vendor, and continued low margins all translate to much greater capital requirements for the clearing vendor. As a correspondent, your clearing vendor's capital reserves and a demonstrated commitment to the clearing business is absolutely critical to your competitiveness.

The cost of building a competitive capability will mean that the part-time clearing vendors will diminish in importance. It's very difficult to compete, even in one or two niches in the brokerage business, without spending at least $25 to $30 million on a system. Most of the majors have spent well over $100 million. Right now, half the business is done by the top five clearers and the other half is spread over 340 different clearing vendors. By the end of the decade, the top five or six will control three-quarters of the business and only 100 others will make up the balance.

Still, the business of clearing other brokers' trades has increased. Around the time of the crash, less than 15% of commission revenues came from introducing firms but now that number is well over 20% and will grow to 33%. We in the clearing industry have a lot of growth opportunity if we redefine our roles and show the small self-clearers, through our actions, that we can help them compete more profitably.

HOWARD M. BRENNER

President, Drexel Burnham Lambert Inc.

"Restructuring - Downsizing"

The first thing to do when thinking about restructuring is to define your goals. These goals may be to reduce your fixed costs, increase your profitability, lower your break-even, to make yourself more efficient.

Secondly, you must determine who is going to be part of the team to evaluate this decision. When we looked at our retail business last January, we formed a team of eight senior people and an outside consultant which met once a week with the idea that by April 15 we would reach a conclusion. Next, you must determine how you're going to meet. We essentially met in secret because this was the type of exercise that you don't want rumors floating around.

Third, you've got to determine how to get your information, and sometimes that's very tricky. You've got to have the cooperation of your financial people and your financial analysts, but to a very large degree you do not want to go to the people who are actually involved in the operation because you will spook them. An outside consultant makes this job a little easier.

You have to determine what the effects of changing or exiting one business will be on other parts of your business. How integrally involved in your operation is OTC relative to institutional sales? How valuable is it for the retail and the retail mark-ups? For municipals, how important is it to have a retail distribution as opposed to municipal finance? If you have a corporate finance activity, how important is it to have a research effort and then a distribution capability on an institutional level, because on most underwritings today, 70% to 75% of them are done by the institutional area.

The next issue — are you the right size? When we looked at our operation, we had 1,100 people but heading south with the government investigation hanging over us. We felt you had to have at least 1,900 to 2,000 AEs in order to economically supply the services that we were giving our people. And then you had to look at what was your comparable rate of return on your investment — how much money did you have in this and what were the advantages or disadvantages? Did you have any cost advantages? Could you do business cheaper? Did the fact that you were processing so many trades help in your operation? Did it help in the distribution of your underwritings that some clients wanted major distribution?

You had to determine your market share, what your growth was going to be, what were your strengths and how could you deal with them. Were you competitive? Could you continue to pay up-front dollars, forgivable loans and all of those other nice things to attract salesmen? And you had to recognize your weaknesses.

Based on that, we put together a model. We were doing about $340 million worth of business with 1,100 AE's and a production per AE over $300,000 per man. How many more AEs do you need to raise your rate of return, to raise your earnings? This said to us that we could not break even in that business until we had 1,900 AEs, and we could not get to 1,900 AEs until 1992, which meant that we had to look at red ink in 1989, 1990 and 1991.

Then there was a very major and tricky issue to deal with. We were charging retail about $72 million worth of allocated expenses which, if you closed retail down, you would have to lower costs by $72 million just to break even. Where do you now allocate research? How and where do you cut people and still remain as efficient? Computers do not go away. You've got this big massive IBM computer, you've paid for it, you're running it — the fixed costs of that are not going to go away. You probably have a network that goes around the country. Are you going to close your institutional branches or leave them open? Can you get the costs out of your network? If you have an international network, you can't lower many costs. You have your order matching systems that go to the floor of the New York Stock Exchange and various other exchanges. To a degree, they're not going to change.

Corporate overhead — is it going to go away? You have a major advertising campaign that you charge across a broad spectrum. Will you be able to continue to do that or not? In our case, we were able to cut $75 million out of overhead but we had a unique case where approximately 10% of our revenue came from retail but it was running at a loss. We lost 4,000 people in the restructuring and at the time, it looked like a very wise decision.

There are a lot of costs of getting out of a business and you've got to figure those costs in. A very major one is the the Plant Closing Act — which requires everybody who doesn't get a job as part of the transaction to be paid a minimum of eight and a half weeks severance. That is a large, large number. If you are involved in the retail business, you probably gave forgivable loans when you hired salesmen. How do you deal with that?

You have to deal with the asset side of the ledger. Are you going to be able to sell all the offices? Can you get somebody to take them all on? Then you deal with the outside forces. Is it going to be perceived that you're going from being a major full service firm to being a boutique or an institutional firm.

A very major issue that came up with us was the capital issue. We were an employee-owned corporation with only one large outside institutional holder. When we did this transaction there was a loss of equity capital of over $200 million. That was to a degree free money and then suddenly 30% was immediately gone and the other 70% went into subordinated debt which you now had to pay 11% or 12% on. That has to be factored in.

Public relations — how you deal with it with the public, with your remaining clientele base and with your own employees? Is this the start of a major downsizing? Is this going to be part of a larger restructuring? The rumors that will float through an organization during these periods get very hot and heavy. So it does create a morale problem for the total organization.

Downsizing is a complex issue. You have to keep it quiet, you've got to think it through carefully and thoughtfully. Finally, when you do decide to move, you should move very rapidly so as to not lose control of the process.

VOLUME

	FEB. 1990	YTD 1990	FEB. 1989	YTD 1989	% CHG YTD 1990-1989
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	155.9	164.2	169.3	168.8	-2.7%
AMEX (MILS.)*	13.7	14.2	11.8	11.3	26.2%
NASDAQ (MILS.)*	127.5	132.6	133.2	131.3	1.0%
REGIONAL EXCHANGE (MILS.)*	25.0	26.5	27.5	27.0	-1.9%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$99,458	$233,980	$111,971	$236,208	-0.9%
AMEX (MILS.)	2,978	6,769	2,951	5,428	24.7%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	7,846	19,282	8,876	17,447	10.5%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	12,326	29,517	15,401	33,436	-11.7%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	51.1%	49.3%	51.9%	52.5%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	9,764	22,194	10,875	21,881	1.4%
AMEX OPTIONS	2,798	6,553	3,142	6,565	-0.2%
COMMODITY	22,724	47,894	21,691	42,9[illegible]	11.4%

PRICES
(END OF MONTH)

	FEB. 1990	FEB. 1989	% CHG FEB. 1990-1989
DOW JONES INDUSTRIALS	2627.25	2258.39	16.33%
STANDARD & POOR'S 500	331.89	288.86	14.90%
NYSE COMPOSITE	183.07	162.49	12.67%
AMEX MARKET VALUE INDEX	352.90	322.47	9.44%
VALUE LINE COMPOSITE	239.68	242.95	-1.35%
NASDAQ COMPOSITE	425.83	399.71	6.53%

YIELDS
(MONTHLY AVERAGES)

	FEB. 1990	FEB. 1989	% CHG FEB. 1990-1989
BOND BUYER INDEX (20 BOND)	7.22%	7.44%	(22)
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	9.22	9.64	(42)
Baa CORPORATE	10.14	10.61	(47)
RATIO Aaa CORPS. TO Baa CORPS.	0.91	0.91	0

UNDERWRITING

	FIRST QUARTER 1990	FIRST QUARTER 1989	% CHANGE 1990-1989
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$78,918.2	$72,373.0	9.0%
Common Stock	$7,125.6	$3,899.5	82.7%
# of Common Stock Issues	114	68	67.6%
Preferred Stock	$1,314.8	$559.3	135.1%
# of Preferred Stock Issues	23	13	76.9%
Corporate Debt	$70,477.8	$67,914.2	3.8%
# of Corporate Debt Issues	1275	850	50.0%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$15,538.1	$18,134.9	-14.3%
# of Issues	661	967	-31.6%
Competitive	$7,825.1	$6,558.2	19.3%
# of Issues	774	772	0.3%

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
SOURCES - - The Securities Executive's Guide to Products & Services 1990-1991	Easy-to-use buyer's guide to products and services directly related to the securities industry. Directory listings of firms provide a brief description of company's specialization, along with address, phone and contact person.	SIA Publications Department Price: $5.00
"Little Action in the First Quarter"	First-quarter underwriting rankings. Merrill clings to overall lead as first quarter sees dramatic new mix of securities. Strong gains in mortgage- and asset-backed securities make up for drops in investment grade and junk debt, but just barely. Investment grade offerings dropped 22.2% compared to 1989's first quarter, from $32.9 billion to $25.9 billion. Industrial corporations, concerned over the direction of rates, either turned to their commercial paper programs or simply waited for the rate picture to come into focus.	Investment Dealers' Digest, April 9
"Do Margin Requirements Matter? Evidence from U.S. and Japanese Stock Markets"	In considering whether margin requirements are an effective policy tool in curbing volatility, this article reviews evidence on the relationship between margin rules and volatility in the U.S. and offers new evidence drawn from the Japanese experience with margin requirements. Given that margin requirements have changed only 22 times in the U.S. in the last 55 years, the authors turned to the Japanese market where margin requirements have changed over 100 times in the past 35 years. Using the Japanese data for analysis, the authors concluded that margin requirements are quite effective in curbing gyrations in stock prices.	Federal Reserve Bank of New York Quarterly Review Winter 1989-90
NYSE Fact Book	Statistical "portrait" of the exchange community and market activity in 1989, with extensive historical data.	NYSE Publications Department

Item	Description	Source
Emerging Stock Markets Fact Book 1990	Reference source containing various time series of fundamental market data on more than 30 stock markets of the developing world. Fact book divided into 6 sections, which include an overview of emerging markets, stock market indexes, and a directory of stock exchange operations listing the addresses and principal officers of the major stock exchanges.	International Finance Corporation, 1818 H Street, Washington, D.C. 20433
"Implication of Introducing U.S. Withholding Taxes on Foreigners' Interest Income"	Study concludes that introduction of a 30% U.S. withholding tax on foreigners' interest income would make the U.S. better off if foreign governments do not retaliate. The trade balance would be improved only in the short run and exacerbated in the long run. If foreign governments retaliate the global efficiency losses associated with the new U.S. tax are enlarged. In terms of discouraging capital flight to the U.S. and related tax evasion, the author concludes there are other policies with less serious efficiency costs that might be equally effective.	Tax Policy and the Economy National Bureau of Economic Research, MIT Press Cambridge, MA 02142
Clearance and Settlement Reform -- The Stock, Options and Futures Markets Are Still at Risk	This report evaluates the sufficiency of industry and federal regulator actions in response to clearance and settlement recommendations made by the President's Working Group after the October 1987 crash. To examine the stock, stock options, and stock futures with respect to clearance and settlement, the study reviews federal, clearing organization, and exchange documents, including reports and regulations. Concludes: Certain clearance and settlement problems that occurred during the crash have been solved, but others remain uncorrected. The greatest progress has been made in upgrading trade processing systems.	U.S. General Accounting Office P.O. Box 6015 Gaithersburg, MD 20877

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SIA
SECURITIES INDUSTRY ASSOCIATION

TRENDS

An Analysis of Emerging Trends in the Securities Industry

Produced by the SIA Research Department

Vol. XVI, No. 4 May 31, 1990

"FROM RICHES TO RAGS"

Performance of the Securities Industry in 1989

HIGHLIGHTS

1. Securities industry profitability has drastically declined during the 1980s: pre-tax ROE fell from 50% in 1980 to an average of 7% the last three years while profit margins, well into the double digits in the early 1980s, have averaged under 4% since 1987.

2. Although industry revenues shot up 15% last year to $60 billion, the first real increase since 1986, expenses expanded a greater 17% — net result: a 26% slash in profits to only $1.8 billion, the third lowest showing of the Eighties.

3. Private placements rose over 10-fold in the 1980s to $200 billion and, unlike the public market, showed no signs of slowing down after 1986. Strikingly, privately placed equity, for the first time ever, matched underwritten equity in 1989. Also, private placements raised more money in 1989 than was publicly underwritten before 1986.

4. In almost every quarter since the Crash, Large Investment Banks' profits have equaled or exceeded all other firms' profits combined. Further, in 1989's closing quarter, the LIBs posted a $31 million profit vs a $122 million loss for all other firms.

5. From the Crash through the first quarter of 1989, Regional firms appeared to be riding a one-way profitability bobsled — downhill. But as retail activity returned during the second quarter, Regionals' commissions and profits blossomed and their 1989 pre-tax profit of $215 million doubled their 1988 performance.

6. The trend towards proprietary trading has been one of the most fundamental changes in the securities business since the introduction of negotiated rates. Trading gains, alone, now account for $12 billion, about one-fifth to one-quarter of industry revenues.

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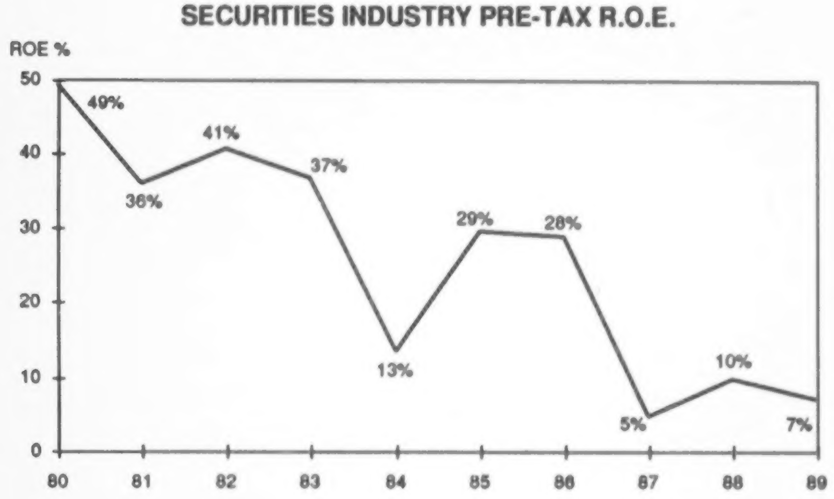
PERFORMANCE OF THE SECURITIES INDUSTRY IN 1989

INTRODUCTION

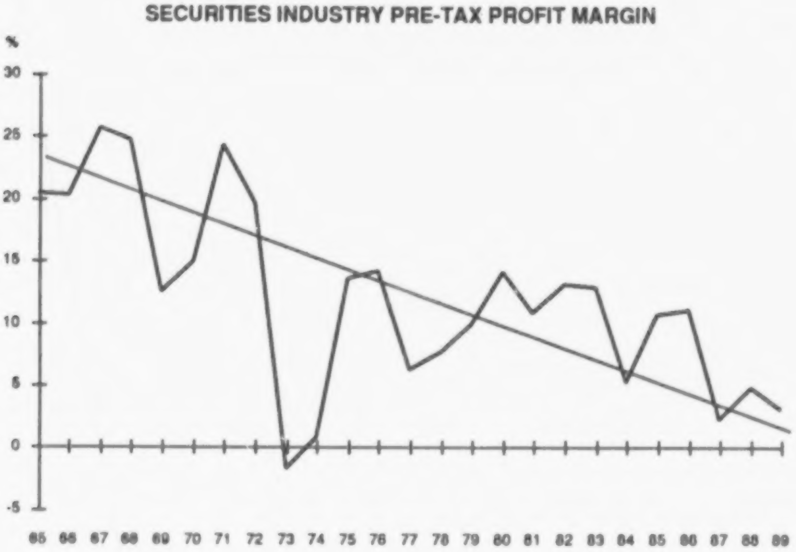
The securities markets and industry opened the past decade with a roar and ended it with a whimper. It is virtually impossible to think of other industries whose fortunes changed so quickly and greatly. All indicators of industry performance show dramatic changes over the past decade. In 1980, the securities industry earned a pre-tax ROE approaching 50%. In 1989, this same measure of profitability was under 7%. Indeed, from 1987-89, the industry averaged a pre-tax ROE of only 7%. Clearly, under such conditions, securities firms could have fared better by placing their capital in Treasury or corporate bonds which face minimal risk vs the volatile and high risks of the securities industry.

Chart 1



Another key indicator of industry performance also shows a dramatic long-term decline, particularly during the 1980s. In the early part of the decade, profit margins averaged well into the double digits after a long climb back from unprofitability in the early 1970s. During the last few years, such margins were very depressed, averaging 3.7% from 1987-89. Last year, profit margins were 3.1%, the second lowest level of the decade. As Chart 2 suggests, the returns earned in the 1960s when the industry was smaller, agency commission oriented, and protected by fixed commission rates, are probably gone forever.

Chart 2



REVENUES AND EXPENSES

Revenues rose from $16 billion to almost $60 billion for New York Stock Exchange member firms dealing with the public. These revenues are for the NYSE members' broker-dealer units as reported on their FOCUS Reports*; the level of revenues at the holding company is much higher (see Appendix).

This 3.7x revenue increase is certainly impressive. Unfortunately, costs rose even faster: 4.2x, or from about $14 billion to $58 billion by the close of the decade. Last year, we had the first significant jump in revenues in three years — an $8 billion increase to $59.5 billion. Unfortunately, after remaining unchanged in 1987-88, costs spurted more than this $8 billion to a total of $58 billion. This inability to keep costs from rising as fast, or faster, than revenues constantly plagued profitability at securities firms since the industry first showed a rapid pace of growth during the mid-to-late 1970s.

The net result is that pre-tax profits amounted to only $1.8 billion last year, the third lowest showing of the Eighties — only slightly better than 1984's weak performance and crash-impacted 1987. The largest non-interest expense for almost every securities firm is compensation and thus it should be the focal point of any cost cutting and profitability analysis. However, even after the severe workforce cutbacks (now approaching 20%) post-crash, per employee compensation continues to rise even as profits plummet (Chart 3). Part of this stems from the fact that the workforce reductions concentrated heavily on trimming low-end producers (leaving the remaining workforce a higher compensated and higher producing group as a whole). On the non-producer side, the reductions also concentrated on the lower cost employee — the bulk of departmental trimming began with staff overcapacity and the first to go were part-timers, temps, etc., but rarely the higher paid department heads or key staff.

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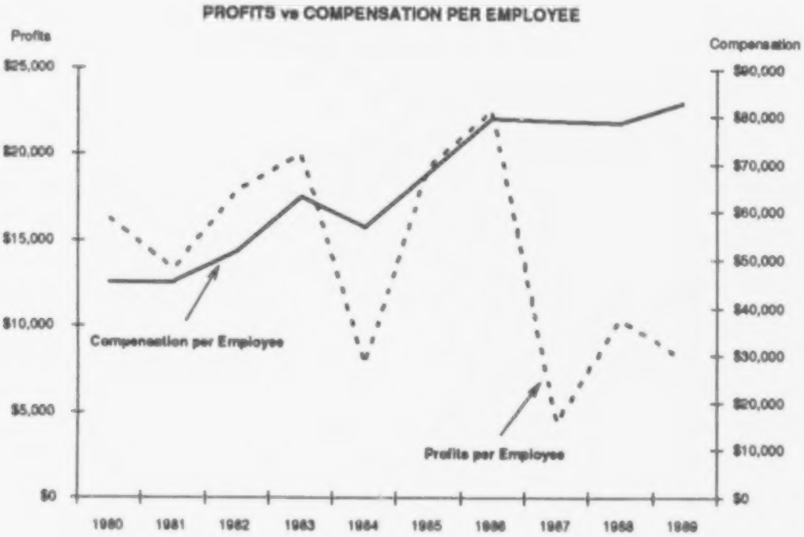
* Financial and Operational Combined Uniform Single Report, required of all broker-dealers registered with the Securities and Exchange Commission to be periodically filed with the Commission and with the broker-dealers' primary Self Regulatory Organization, i.e. the New York Stock Exchange or the National Association of Securities Dealers.

Chart 3



Nevertheless, securities industry compensation practices also contribute to this rising expense. Some practices are a holdover from a partnership era, such as firm-wide bonuses often in extreme proportions to profits, or even during periods of losses; and payments to both profitable and unprofitable departments on the premise that the business cycles will even this out in the end (and, with some businesses now possibly permanently unprofitable or marginal, it may not).

Even incentive compensation in the securities industry is almost always tied to how much revenue is generated, not profits, which will just perpetuate the industry's trend of growing revenues and declining profits. Compensation is often irrational, i.e. systems and secretarial personnel working for capital markets may be compensated vastly greater than the same functionaries in operations, even though they basically perform the same function. Also, the industry tends to compensate many functionaries on a higher scale than their counterparts in other industries. Further, firms strive for higher producer compensation in order to retain high producers. The fear, and a justified one, of losing producers to competitors also tends to create payment structures which retain both the unprofitable as well as profitable producers. Again, a revenue driven grid.

Labor deserves its rewards, as does capital, but as long as securities industry compensation practices stem from the old "partnership philosophy" or revenue as opposed to profit-driven formulas, profitability will continue to suffer. These practices, or the practitioner, will not last long in an industry which remains in a lower margin, more competitive environment relative to earlier years.

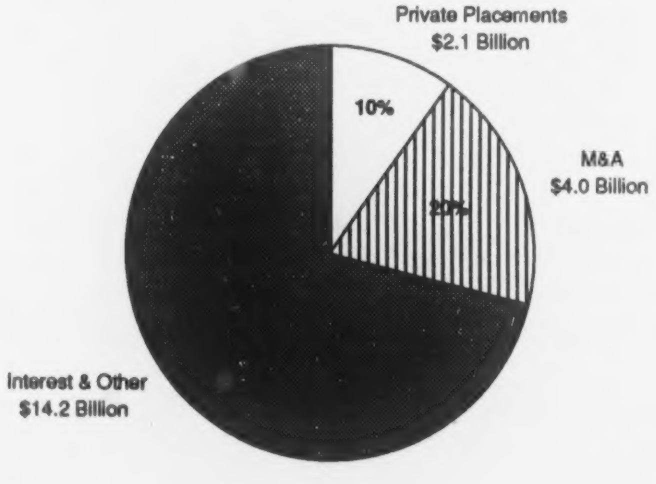
Revenues Related To The Securities Business

Last year's $8 billion revenue increase was attributable to the three main categories: commissions, trading and investment gains, and "revenues related to the securities business", although not necessarily in that order. Indeed, significant changes have occurred in the last decade in the relative importance of these three most important revenue categories. Commissions, which accounted for 35% of revenues in 1980, accounted for only 17% by decade's end. Trading and investment gains have undergone the least change in relative importance. These revenues opened the decade by accounting for 23% of the industry's gross; they closed the decade by contributing to 21.5% of total revenues. The most dramatic development has been the explosion in the relative importance of "other revenues related to the securities business," going from less than 11% in 1980 to over 34% by the decade's close.

As noted in earlier issues of Trends and illustrated in Chart 4, this revenue component is comprised mainly of three activities: fees from M&A, fees from private placements, and interest income (sometimes net and sometimes gross). Actually, although this revenue line showed uninterrupted growth during the 1980s, it was during 1987-89 that it had its most dramatic growth — spurting from 19% of gross revenues at year-end 1986, to over 34% by last year. During this time span, this revenue line more than doubled from $10 billion (1986) to $20 billion (1989). At the same time, other revenues were stagnating or coming under increased pressure.

Chart 4

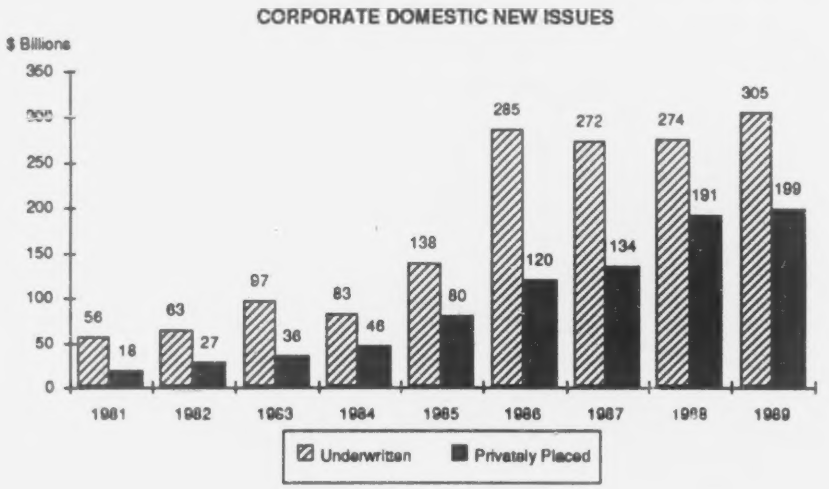
OTHER REVENUE RELATED TO THE SECURITIES BUSINESS



Private Placement Activity

In reviewing the components of revenues related to the securities business, it is apparent that M&A activity and private placements showed dramatic growth during the past decade; particularly, during the last half of the decade. As shown in Chart 5, private placements rose 10-fold in the 1980s from less than $20 billion to almost $200 billion Indeed, while financing activity in the public markets showed signs of slowing down after 1986, there was no such trend in the private placement market. Both debt and equity offerings increased in the private placement market. Strikingly, the amount of equity raised in the private placement market in 1989 matched, for the first time ever, the amount raised in the public markets. Without distinguishing by type of capital raised, the private placement market accounted for about 40% of total funds raised domestically in 1988-89 compared to around 20% in 1980. More money was raised in the private placement market in 1989 than was raised publicly before 1986. The private placement market is now a meaningful competitor to the public markets for entities seeking capital and will be even more so with this Spring's passage of Rule 144A by the SEC.

Chart 5

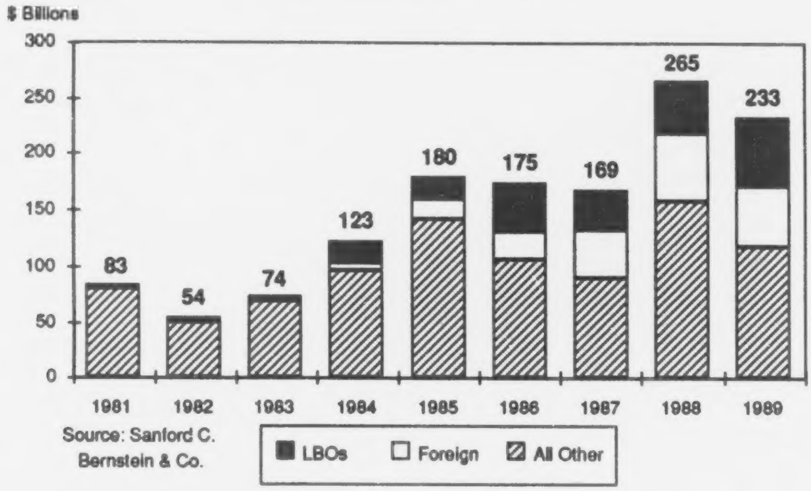


M&A Activity

M&A activity has received more attention from the press, Washington and State Capitals because of its ripple effect on shareholders, employees, vendors, and communities in general. Frankly, however, when it comes to the structure of the U.S. capital market itself, we think what has happened in the private placement market may be a larger and more fundamental change. As expected, M&A activity shows dramatic growth during the past decade from slightly over $80 billion in 1981 to $240 billion last year. Not until 1984 did LBOs become a real factor in this development. With the recent upheaval in the high yield bond market and some of the more leveraged deals in real economic trouble, this trend may have peaked in the 1980s. Again, it appears that the development of the private placement market with the necessary infrastructure in place may be a more fundamental change to the capital raising mechanism than the more controversial and publicized reorganization of Corporate America through mergers and acquisitions. Although there are substantial fees involved for investment bankers in such activity, there are also greater risks, particularly when their own capital is employed. As Chart 6 shows, the sharp increase in M&A activity also helps explain the dramatic increase in revenues related to the securities business.

Chart 6

MERGERS & ACQUISITIONS



Source: Sanford C. Bernstein & Co.

Repo Business

The interest component of "other related" revenues is more difficult to estimate; one reason alone is the inconsistent reporting by firms (net vs gross). However, reverse repurchase agreements have grown dramatically on the balance sheets of securities firms thereby generating significantly larger sums of money. At year-end 1980, these securities were valued at $31 billion in assets for the industry; by 1989 they were $220 billion. Meanwhile, repos, as liabilities, grew from $31 billion to $278 billion during the same time frame. This underscores the dramatic growth in the use of these instruments as a means of securities firms raising short-term money for clients and themselves and generating interest income.

OTHER REVENUE SOURCES

Commissions

For the industry, commissions rose 16% last year (Chart 7) as volume on the NYSE increased only 2.5%, from 161.5 million shares daily in 1988 to 165.5 million last year. Most of the growth in commissions was due to an 11% increase in the average price of a share traded from $33.20 in 1988 to $37.00 last year. Other marketplaces also enjoyed increases in the volume of trading and stock prices. For example, daily volume on the Amex expanded from 9.9 million shares daily in 1988 to 12.4 million shares daily while the average price of a share traded rose from $12.29 to $14.21. On NASDAQ, volume went from about 123 million shares daily to 133 million shares daily, while the average price of a share traded also rose form just above $11 to slightly below $13.

Chart 7

SECURITIES INDUSTRY INCOME STATEMENT

(In $ Millions)

REVENUE:	1988	1989	88 - 89 % Change
Commissions	8,790.5	10,150.7	15.5%
Trading Gains	11,299.1	12,343.3	9.2%
Investment Gains	1,394.2	488.1	-65.0%
Underwriting Revenue	5,158.2	4,120.0	-20.1%
Margin Interest	3,028.5	3,723.1	22.9%
Mutual Fund Sales	1,413.3	1,579.5	11.8%
Fees, Account Supervision	1,884.8	2,225.8	18.1%
Research	23.1	27.1	17.3%
Commodities	1,382.3	1,407.6	1.8%
Other Securities Related	14,693.1	20,337.5	38.4%
Other Unrelated	2,761.9	3,134.4	13.5%
TOTAL REVENUE	51,829.0	59,537.1	14.9%
EXPENSES:			
Total Compensation	18,739.4	18,825.8	0.5%
RR Compensation	7,580.6	7,539.3	-0.5%
Clerical Compensation	9,280.5	9,103.2	-1.9%
Floor Costs	1,756.2	1,855.4	5.6%
Communications	2,548.8	2,374.2	-6.9%
Occupancy & Equipment	3,052.4	3,163.3	3.6%
Promotional Costs	1,003.5	954.6	-4.9%
Interest Expense	16,308.2	24,069.8	47.6%
Errors, Bad Debts	438.1	421.8	-3.7%
EDP	736.6	710.7	-3.5%
Regulatory Fees	371.9	437.5	17.6%
Non-Recurring Charges	56.1	239.8	327.5%
Other	4,325.5	4,642.2	7.3%
TOTAL EXPENSES	49,336.7	57,695.1	16.9%
PRE-TAX NET INCOME	2,492.3	1,842.0	-26.1%

The $10.2 billion in commissions was the third highest during the eighties; while, the $7.6 billion earned on commissions from listed equities was the second highest. Basically, this revenue source could not compensate for the fall off in activity in the listed options area which has remained sharply depressed since 1986-87. The dramatic decline has occurred specifically in options on stock indices which are back to 1984 levels. This pattern is similar to futures on stock indices, particularly the popular future on the S&P 500 index.

The slow recovery in commission revenues is startling when it is widely acknowledged that stock prices performed handsomely since year-end 1987. Since then, the DJIA, S&P 500 and NYSE Composite Index all increased by about 40%. The Amex index has increased by an even higher percentage. Only the smaller capitalized stocks increased at a slower rate, and their increase of 25%-35% is nothing to be ashamed of. Based on these figures, we conclude that the Crash of 1987 left a permanent scar on institutional and individual investors who have chosen to stay on the sidelines with their equity holdings and have turned more and more to fixed income and short-term securities.

Mutual Funds

Sales of mutual funds indicate the change in investor appetite for different securities. In 1970, equities accounted for 81% of all assets in mutual funds with bond income funds comprising the remaining 19%. Then, came the development of money market funds in the late 1970s. By 1980, they accounted for 65% of the assets in all mutual funds. These funds continued to grow in relative importance in the early 1980s, until the explosive growth in equity mutual funds and bond and income funds in the mid-Eighties which continued until 1987. The growth in revenues from mutual fund sales follows the pattern of sales of equity mutual funds and bond funds. There was a slight recovery in 1989 as both equity mutual funds and bond funds recovered some of their earlier popularity. Since 1985, there are more assets in bond and income mutual funds than equity mutual funds.

Proprietary Trading

The trend towards proprietary trading has been one of the most fundamental changes in the securities business since the introduction of negotiated rates. As the profitability of the agency business declined, securities firms turned to other business activities to bolster their profitability. One of the most natural was taking principal positions in securities. Bond trading gains (losses) and OTC market making dominates this activity. Other trading activities, such as arbitrage and other niche trading specialities, have also come into their own during the last few years. In total, trading gains have grown to a $12 billion business and account for about one-fifth to one-quarter of industry revenues.

Also showing impressive and steady growth from 1980 until 1987 was investment gains for firms' own accounts. However, the post-crash world has demonstrated just how volatile taking positions in companies can be. The less than $500 billion earned last year was the second lowest figure for the decade as many earlier deals turned sour. The natural procession of the industry from acting as agent, to taking positions in securities, to taking positions in companies has not been without risk as some of the latest LBO deals demonstrate vividly.

Money Management Fees

Despite the risks taken by the industry in the proprietary field, it has been very successful in attracting funds to manage, a much less risky, but nonetheless extremely competitive field. Fees from money management activities have grown from $175 million to $2.2 billion last year. The strategy of collecting assets and managing those assets while moving away from transaction fees seems to be working and is counter-cyclical to other more volatile revenue sources. This growth has been similar to the revenues related to the securities business without the same volatility and with different firms being the major factors as noted later in this report.

EXPENSES

It is clear from the decline in profit margins that the growth or expansion of expenses exceeded revenues during the 1980s. At the beginning of the decade, expenses amounted to less than 86% of revenues. During 1989, expenses ate up just under 97% of revenues. The cost item that has accounted for most of the increase in expenses relative to revenues is interest , which grew from $3.4 billion in 1980 to over $23 billion in 1989. As a percentage of revenues, interest expense has about doubled, from 22% in 1980 to 40% last year. Although FOCUS interest reporting doesn't allow for analysis of net interest income, and there have been periods of strong profits from this area, it is still obvious that if the securities industry could find a way to lower or cut interest expense, this would mean a significant change in profitability and deserves intense study by firms.

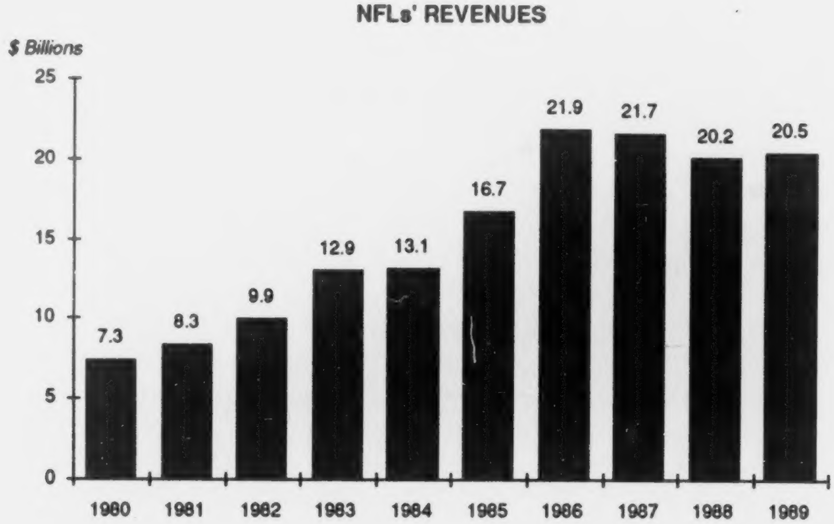
Until last year, interest expense was second to compensation as the largest cost component. Compensation expenses have declined from almost 40% of revenues to about 32% of gross. The decline only occurred during the past two years and much of it is due to the drop in RR compensation as a byproduct of a drop in gross production or in other words, a drop in their revenues. Indeed, until 1987, RR compensation exceeded compensation to other employees. This relationship changed abruptly in 1988 and continued last year as clerical compensation exceeded RR compensation by almost $2 billion annually. Also, as noted earlier, much more work is needed on industry compensation practices beyond headcount reduction in order to tackle declining profitability.

There are other expenses that continue to trouble the industry relative to revenue growth. Communication costs have declined only slightly relative to revenues going from 5.2% in 1980 to 4% during 1989. Meanwhile, occupancy and equipment cost rose from 3.2% of revenue to 5.3% last year. Because of the dramatic growth in interest expense relative to revenues, almost every other cost line shows a relative decline with respect to revenue growth. This should not be interpreted that during the 1980s, firms had a firm handle on controlling expenses. To the contrary, it appears that, for the most part, the industry remains mainly revenue driven and market share oriented. In part, we believe this is attributable to the great difficulty in estimating account and product profitability because of the many assumptions involved in allocating joint costs and facilities among different products and services.

NATIONAL FULL LINE FIRMS

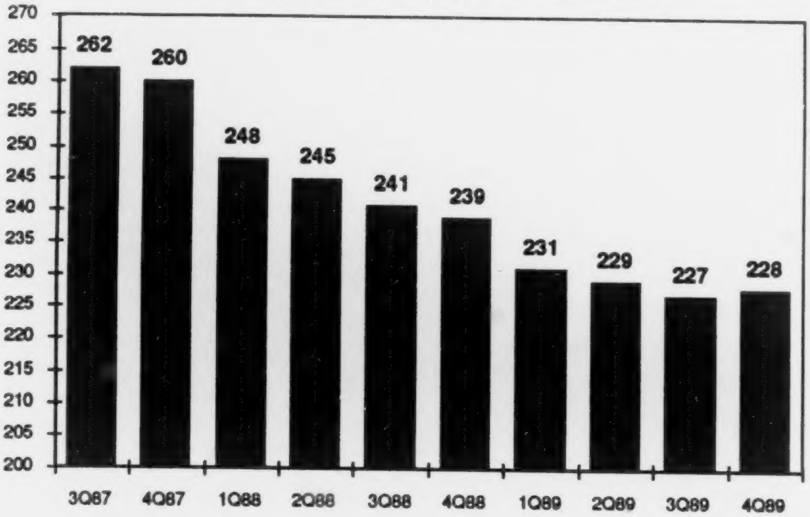
Total revenues for the National Full Line firms (NFLs) improved only fractionally last year but is still below their peak levels of 1986 and 1987 (Chart 8). Although these revenues are for the NFLs' broker-dealer units, the NFLs' holding company revenues, while twice as large, have also shown little or no growth in recent periods. The NFLs' revenue stagnation is the result of several factors. First, there has been some consolidation within the group: 1989 results (from which this data is derived — see Appendix) no longer include E.F. Hutton, though some of its former activity is still reflected in Shearson.

Chart 8



Second, many of the NFLs' main business lines have been under constant pressure since the Crash, i.e. retail, mutual fund sales, etc., and so the NFLs have also been consolidating intra-firm — scaling back operations to reflect the lower level of business. Hundreds of branch offices have been closed or consolidated; back office functions have been scaled down, and correspondent clearing services have even been dropped by a major NFL firm. The bottom line shows employment is down 15% at the NFLs since the Crash, from 150,000 just prior to the Crash to 128,000 at 1989's close. This group, comprising the bulk of the industry's overall as well as retail employment (about 60%), also has absorbed the bulk, 64%, of the industry's workforce cutback (industry cutback shown in Chart 9). Obviously, the levels will be down even further in 1990 with the loss of several firms, Drexel, Thomson McKinnon, etc., and further cutbacks announced at other NFLs.

Chart 9



SHRINKING EMPLOYMENT SINCE THE CRASH

Securities Industry Employment in Thousands

Commissions, one-fifth of the NFLs' revenue stream, hovered around $1 billion per quarter in 1989, below 1986-87 levels but still above 1988 or 1985 commissions. Trading gains of $5.1 billion matched 1988's level and were second only to 1986's record $5.5 billion. However, during the second half of 1989, trading waned somewhat, mainly from woes in the junk bond market.

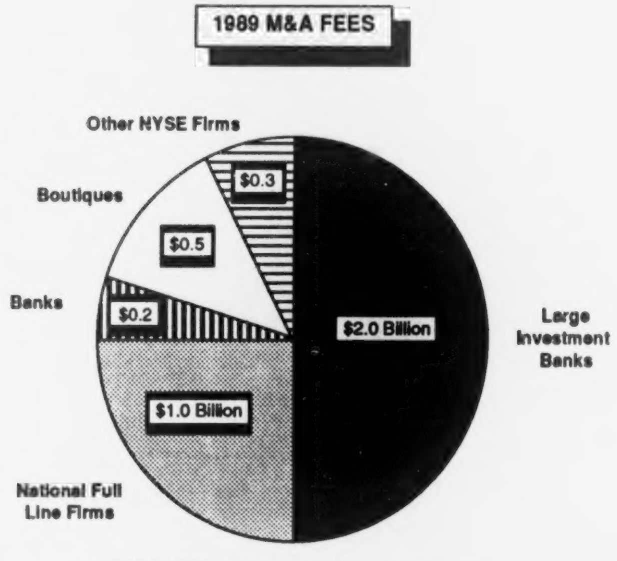
One area severely hit: gains from firm's own investment accounts. This fell 90% last year to only $20 million, the third lowest of the decade, and there was even an absolute loss of $17 million in the fourth quarter. A good portion of this reflected losses from equity positions in prior LBO deals gone sour. Underwritings, which got off to a horrendous start in the first quarter, only improved slightly for the balance of the year with a net result of $1.8 billion, the lowest underwriting revenue for this group since 1984, itself an off-year.

Margin interest climbed to a record $1.8 billion, even exceeding underwriting revenues, a rare occurrence in recent years. However, it wasn't that lofty a record since margin revenues have steadily earned between $1.2 billion and $1.7 billion annually throughout the Eighties, a time when total revenues tripled for the NFLs. Also, the publicly held NFLs all had hefty net interest income at the holding company level, although the largest firms showed some slippage from their year-earlier results.

Mutual fund sale revenues improved about 10% last year to $1.2 billion, but this still only matches 1985's results and falls far short, nearly half, of the NFLs' record $2 billion generated in 1986. One bright spot has been asset management fees. This area continued its explosive growth of the 1980s, with consecutive new highs substantially exceeding the previous year's record. Last year, NFLs' asset management fees broke the billion dollar barrier rising a whopping 44% to $1.2 billion (with substantial additional amounts generated outside the NFLs' broker-dealer units).

Still, asset management is dwarfed in importance by the "Other Revenue Related to the Securities Business" line, which reflects the "hot" areas of M&A, private placements and repo interest. Here the news was bad for the NFLs. Bucking the industry trend, the NFLs again showed a decline in this area, with revenues now down to only $3.5 billion, the lowest showing since 1985. Part of this drop came from lower M&A fees and the fact that the NFLs are not the powerhouses in the M&A area as are the LIBs. Only Drexel, Merrill and Shearson have a significant presence and Drexel, the biggest of the three in this area, is now gone. NFLs earned $1 billion in M&A fees last year (Chart 10), half of the LIBs' earnings and 29% of the NFLs' "other related" revenues.

Chart 10

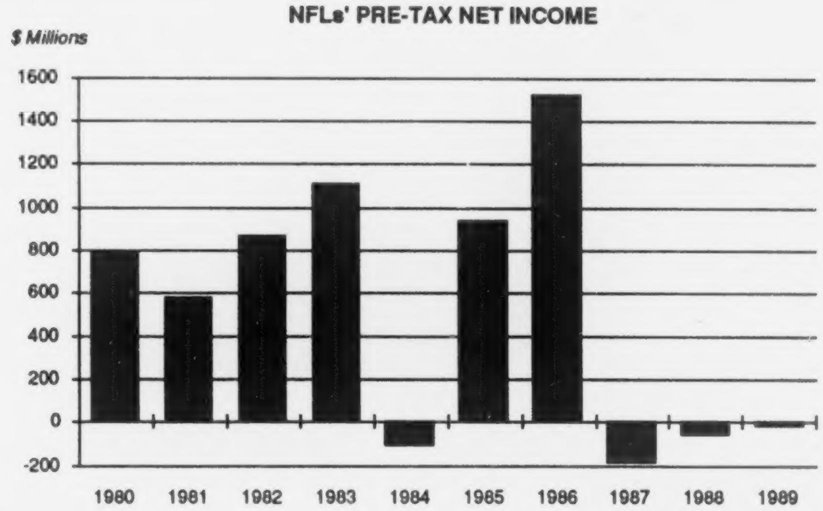


1989 ESTIMATED M&A FEES TOTAL $4.0 BILLION

Similarly, of the NFLs, only these three firms plus PaineWebber have a significant share of private placements fees. All told, NFLs have about $900 million in fees from this area, the same as money center banks but slightly less than the LIBs' $1.2 billion. Last year, private placements accounted for one-quarter of the NFLs' "other related" revenues. Finally, the biggest factor in the NFLs' declining "other related" revenue is a two-thirds reduction in the group's repo and reverse book (and related interest) resulting from a merger.

The bottom line from these revenue problems: 1989 was the third consecutive year in which NFLs broker-dealers have posted losses, although the red ink is getting smaller (-$193 million in 1987, -$68 million in 1988 and -$25 million last year — see Chart 11). However, these losses are in the broker-dealer units while NFLs' holding company results, while still poor, were not in the red for any of these years (see Appendix).

Chart 11



It's not just poor revenue performance penning this red ink. Expenses at the NFLs doubled from 1983 to 1986 and have not been curtailed to any extent since. Interest expense returned to record levels last year at $4.6 billion, and accounted for a record 22.3% of total revenues. This is tempered somewhat by the belief that the NFLs also earned positive net interest income at the holding company level, although FOCUS reporting does not allow for this type of analysis. For the publicly-held NFLs, the holding companies reported strong net interest income although somewhat below 1988's levels.

Also a contributor was occupancy & equipment expense which continues to climb to record levels. However, although record costs have been posted every year, the growth was finally slowed — less than 2% growth in 1989 vs 8% in 1988, 24% in 1987 and 16% in 1986. Meanwhile, communication costs were trimmed slightly to pre-1987 levels but EDP costs hit a new high.

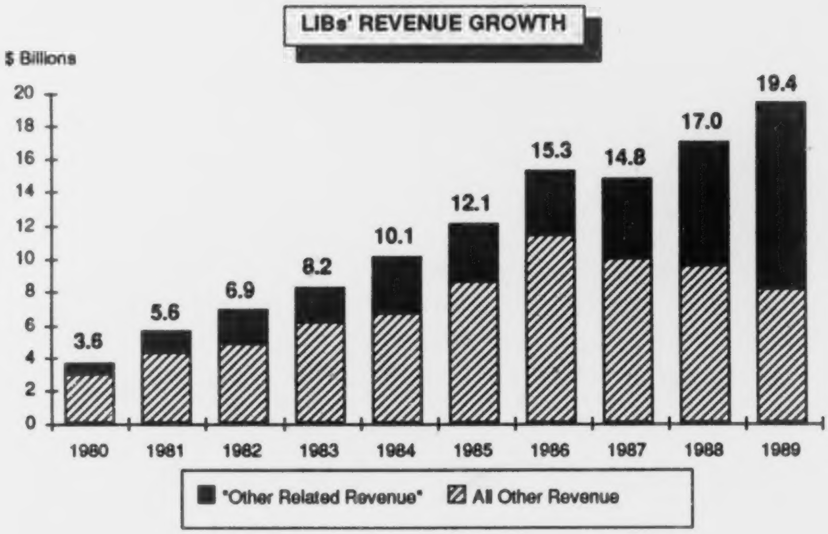
Non-recurring charges exploded seven-fold to, by far, a new record $182 million, most likely attributable to Merrill Lynch's fourth quarter restructuring charges including employee termination costs. Again, FOCUS fails us — at the holding company level, Merrill reported a $470 million pre-tax restructuring charge which means, at best, only a third of the total was reflected in FOCUS. This new record is assured of quick extinction since Shearson just announced a first quarter restructuring charge of $650 million (although just how much will filter down to FOCUS is unknown).

The only bright news on the expense side of the ledger was compensation costs. For the second year in a row, the NFLs' compensation costs were reduced, last year by 6% to $9 billion, the lowest level since 1985 and a full 15% below 1987's record $10.6 billion total. That compares with an 11% cut in total employment from 1987's peak. Both RR and clerical compensation were also at their lowest levels since 1985. Nevertheless, the NFLs also suffer from a rising comp per employee trend as seen earlier. Total comp is down because of the total cuts but we would be much more optimistic if there were improvement in compensation costs within the remaining workforce.

LARGE INVESTMENT BANKS

With the exception of crash-impacted 1987, Large Investment Banks (LIBs) set revenue records every year during the 1980s. Last year, revenues rose 14% to $19.4 billion (also 14% at the holding company level, to $31 billion — see Appendix). Last year's $2.4 billion increase in revenues was more than accounted for by a $3.7 billion, or 50%, increase, in "Other Revenue Related to the Securities Business." As mentioned, the "hot" areas of M&A, private placements and interest income have been driving the industry's, and particularly the LIBs' growth. In fact, this area is now two-thirds of the LIBs' total revenues, up from less than 20% back in 1980, and last year's "other related" revenue exceeded the LIBs' total revenues only five years ago. As Chart 12 illustrates, revenues from other sources (particularly trading) have actually declined since peaking in 1986.

Chart 12



However, we estimate that of the $11.2 billion in "other related" revenues earned last year, $2 billion, or 18%, was from M&A fees. That compares with $2.5 billion in M&A fees in 1988. As shown earlier, completed M&A deals fell from a record $265 billion in 1988 to $233 billion last year while total fees earned from these deals fell from $4.5 billion to $4.0 billion.

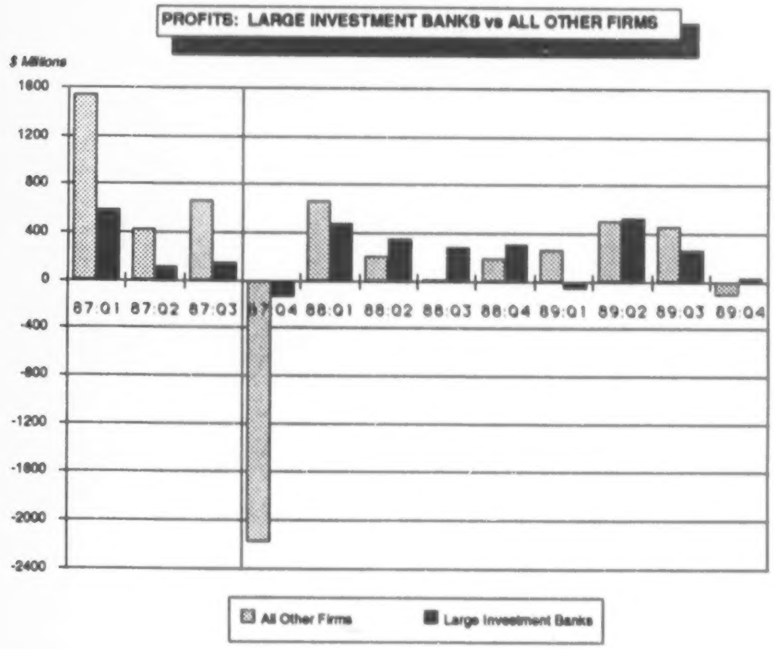
Meanwhile, the LIBs were lead agents on about $80 billion of the record $200 billion of domestic private placements last year, or 40%. This was a slight drop from their 45% share, or $86 billion, of 1988's $190 billion private placement market. We estimate that the fees earned in this area totaled $1.2 billion for the LIBs or 11% of their "other related" revenues. The balance, or 71%, of this line is assumed to be mainly interest revenues. As noted below, the LIBs are assumed to have collectively earned substantial net interest income.

Although last year's trading gains of $3.8 billion matched 1988's level, this still fell far short of 1986's record $5.2 billion. This area accounts for a good portion of the drop off in "all other" revenues as seen in Chart 12. The LIBs' bond trading gains were stronger in the first half, prior to the souring of the high yield market.

Last year, the LIBs also had their worst underwriting performance in five years. The $1.5 billion booked in 1989 represented a 17% drop from 1988's showing. LIBs' asset management fees fell for the first time last year, down 26% or $104 million, to $295 million. Although this drop ostensibly bucks the industry trend, it was the result of at least one and possibly two LIBs shifting sizable asset management operations out of the broker-dealer.

Margin interest hit a record $687 million, a 41% increase over 1988's showing. The flip side shows interest expense once again headed to the stratosphere, logging in at $11.5 billion, a 33% increase and so large a factor that 60% of revenues are now used to cover interest payments. Interest expense's $2.8 billion increase also accounted for nearly the entire $3.1 billion increase in total expenses. However, for at least some LIBs the net result was good. Two of the three publicly held LIBs' holding companies showed strong net interest income while the third showed the opposite, a strong net expense.

Chart 13



For yet another post-crash quarter, the LIBs dominated the industry's profitability scene. In last year's closing quarter, the LIBs posted a $31 million pre-tax profit. While small and substantially down from the previous two quarters, this profit compares to a $122 million loss for all other firms as a group. Of course, the NFLs' fourth quarter loss of $131 million, alone, offset profits from other firm categories. Still, as can be seen in Chart 13, LIBs have equaled or surpassed all other firms profits quarterly since the Crash.

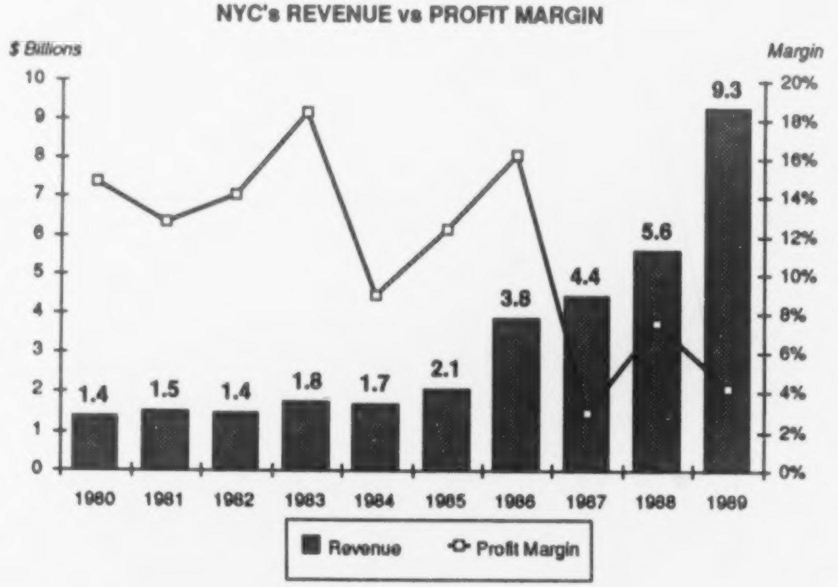
Even though the LIBs remain profitable and showed a healthy 14% revenue growth in 1989, there is no absence of profit pressure with expenses continuing to mushroom. Total expenses climbed a much higher 20% in 1989, halving profits from 1988's $1.4 billion to $750 million last year. In fact, all expenses climbed except communications and EDP costs while interest expense alone rose almost $3 billion.

NEW YORK CITY-BASED REGIONALS

In the early 1980s, the NYC-based Regionals closely mirrored their regional brethren scattered throughout the 50 states. Commissions were about half of their revenues with other sizable contributions coming from trading, margin, underwriting, etc. This rapidly changed during the late 1980s and this group now closely mirrors the LIBs, albeit on a smaller scale. Commissions are only 13% of total revenues, while principal transactions account for one-quarter. And like the LIBs, other and other-related revenues (M&A, private placements and particularly interest income) account for more than half of all revenues.

This group of about 80 firms has shifted its business emphasis more to the institutional side and active principal businesses with a fantastic growth in revenues. Total revenues hovered between $1 and 2 billion annually through 1985, before the business line shift, and then exploded, finally reaching $9.3 billion last year. However, as Chart 14 demonstrates, that growth doesn't necessarily translate into higher profitability.

Chart 14



The past two years have witnessed much of this growth. During this time, assets more than doubled from around $40 billion to $90 billion. Half of this growth came from a doubling of the reverse repo book to $50 billion — nearly half of all assets and a leading contributor to the growth in the "other related" revenue line. On the other side of the ledger, repos grew even faster to $60 billion, two-thirds of total liabilities.

This growth was leveraged since total capital increased only $1 billion over the past three years to $4.5 billion, the number of firms remained at about 80, while employment hovered around 15,000 (basically the only group of firms not to have undergone any downsizing since the Crash).

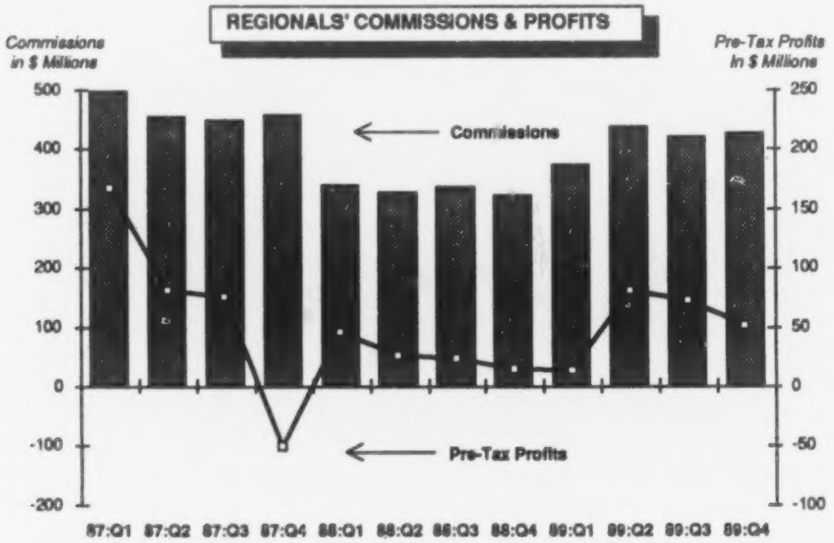
These firms make up just under one-quarter of all NYSE firms and their growth has vaulted their share of industry revenues from 9% in 1987 to 16% last year. The new reliance on interest income has translated into a 25% share of all interest expense in the industry, second to the LIBs' 47% share and drastically larger than Regional firms' 2% share. Also, the 143% increase in interest expense last year was entirely the cause of a 71% increase in total expenses. This outstripped revenues growth of 65%, impressive as that is, for a 7% drop in profits to $386 million.

A final note, the 31 "Large New York City-based" firms, just under 40% of the group's total, dominate 80% to 90% of the groups' revenues, profits, capital, assets and employment.

REGIONALS

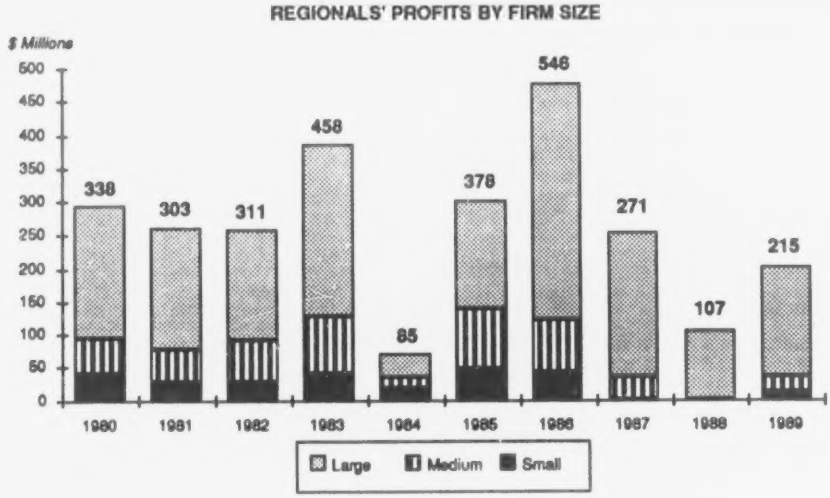
From 1987 through the first quarter of 1989, Regional firms appeared to be riding a one-way profitability bobsled — downhill. Then, beginning in 89:Q2, retail activity began to pick up to the best levels since the Crash (but not quite up to the record levels immediately preceding the Crash) and profitability hopes sprung anew. However, for the remainder of the year, profits again waned but never down to the anemic levels of 1988. The Regionals' profitability levels closely track their level of commission business (Chart 15), one-third their total revenue stream; many Regionals have been trying to diversify their revenue base to avoid this commission dependence.

Chart 15



This small return to profitability was not evenly enjoyed by all Regional firms. Some Regionals showed record profits during certain quarters of 1989 while other Regionals went into receivership or closed. As Chart 16 shows, in general, Large Regionals (revenues exceeding $70 million) have fared the best since the Crash while both Small Regionals (revenues under $20 million) and Medium Regionals ($20 to $70 million of revenues) returned to modest profitability last year.

Chart 16

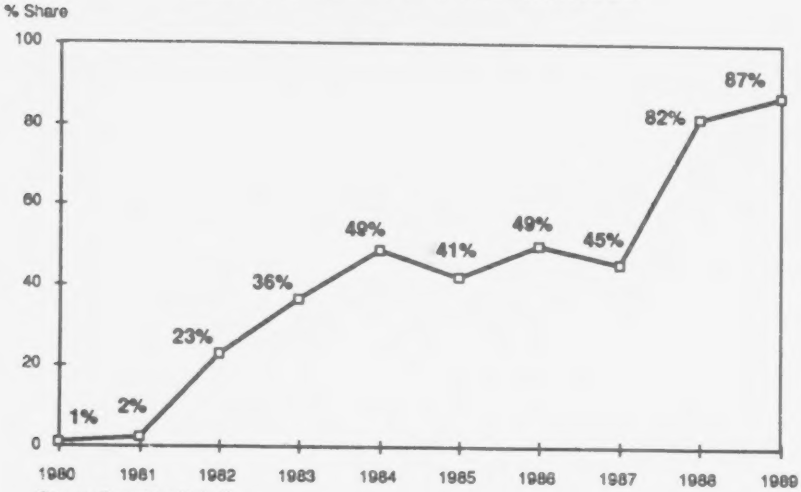


Commissions, still one-third of Regionals' total revenues, rose a solid 25% last year reflecting renewed retail investor interest and bettering the industry average of a 16% increase in commission revenue. Trading gains improved 11% vs 9% for the industry as a whole. These two lines taken together represent the majority, over 53%, of Regionals' revenues.

Underwriting income, about one-eighth of total revenues, held even last year for the Regionals vs a 20% decline industry-wide. However, the decline in M&A related underwritings, high yields and other mega deals does not impact the Regionals to any extent since these deals are no longer syndicated to the Regional level. In fact, 1982's passage of the shelf registration rule by the SEC, Rule 415, effectively signaled the end of most bond syndications as is seen in the Chart 17.

Chart 17

NON-SYNDICATED SHARE OF VALUE OF U.S. DEBT UNDERWRITINGS



Source: Securities Data Co.

Conversely, the Regionals' absence from the M&A and private placement areas left them with a 10% rise in "other related" revenue vs a 38% rise for the industry. Also, this line is only one-eighth of Regionals' total revenues vs one-third for the industry. Other retail areas showing improvement were asset management fees, up 18%, and margin interest, up 23%.

Put together, total revenues rose 17%, a good sign since the industry's 15% average increase was totally dominated by the LIBs' performance. Combining this revenue growth with a slower, less than 15%, increase in costs, Regionals' profits doubled last year. Although that compares to a 26% decline in profitability for the industry (pushed down by the NFLs), we noted earlier that Regionals' profits last year peaked during the second quarter.

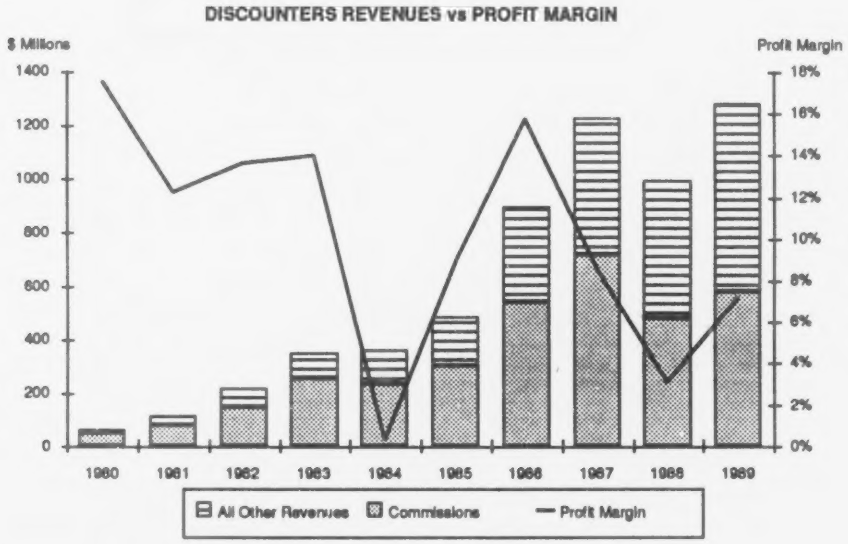
DISCOUNTERS

Discount broker-dealers which are members of the New York Stock Exchange number only about two dozen and their aggregate financials are heavily weighted by a few national discount firms. Even when analyzing the larger universe of all NASD members and their discount brokerage membership, the national discounters still account for about half of many of the aggregate figures.

For most of the 1980s, up until the Crash, Discounters' commissions accounted for about two-thirds to three-quarters of their entire revenue base. Since the Crash, this has fallen to just under half. For the past two years, trading has accounted for an additional 13%, margin interest 17%, and surprisingly, "other related" revenue skyrocketed to 23% last year vs less than 3% back in 1980.

Despite the growth in revenues, and even commissions, Discounters have suffered the same deteriorating margins in the securities business as other firm categories as seen in Chart 18. However, being more commission and retail dependent, the swings, both up and down, in profitability are steeper for this group as retail clients become active or inactive. Also, the cost structure is quite different for this group. Their compensation practice, to work almost exclusively with salaried personnel (only 3% of costs are broker compensation) has kept their total compensation expense at around 25% of revenues throughout the 1980s. Discounters have moved into some institutional areas and the correspondent clearing business and their interest expense has climbed to 24% of revenues from just 3% in 1980.

Chart 18



Still, this niche playing has garnered Discounters an important share of the retail business, about 8% to 9% of retail commissions in recent years. For a further analysis of this group and its' market share, a future issue of Trends on Discounters will be published later this year.

CONCLUSION

The securities industry's constant cost problems, shrinking margins, competitive pressures and the resultant low profitability have created a condition where, clearly, the industry could have fared better by placing its capital in riskless Treasuries and avoided the volatile and high risks of the business today. The high profitability the industry once enjoyed from being a small and somewhat protected (fixed rates) agency business years ago are probably gone forever.

Capital is the name of the game and nearly two-thirds of the industry's revenue stream is derived from businesses where capital is at risk, i.e. trading, underwriting, merchant banking, etc. Though margins are low, it still has been these risk-based businesses, and firms concentrated in them (LIBs, NYCs), that have shown the highest returns in recent years. These businesses carry with them, however, the intendant risks of higher loss along with higher rewards. In such an environment risk controls and cost controls are of paramount importance to profitability and success.

When it comes to costs, compensation and interest expense are by far the two largest components for most securities firms. As a percentage of revenues, interest expense has about doubled, from 22% in 1980 to 40% last year. Although FOCUS interest reporting doesn't allow for analysis of net interest income, as mentioned earlier it is still obvious that the securities industry could improve profitability substantially by lowering its interest expense and cost of capital.

Likewise, although there has been some progress in rolling back compensation costs at some firms, much more needs to be done in this area. Incentive compensation should be tied to profitability as opposed to gross revenues generated. Rational compensation plans should be instituted and maintained which compensate similar functions with similar pay, regardless of the departmental lines they report to. Incentive plans should be geared toward keeping profitable producers and these should be based on profitability measures and not merely gross revenue parameters without regard to the firm's bottom line.

Finally, the 1990s pose many difficult challenges to securities firms and their management. At the same time, it should offer many opportunities to those who can steer a steady course with one eye to the horizon and the other to the bottom line.

Jeffrey M. Schaefer
Senior Vice President and
Director of Research

George R. Monahan
Assistant Director of Research

APPENDIX

FOCUS Reports

The shortcomings of securities industry financial data in general, and of the FOCUS Report in particular, are many and have been frequently illustrated in Trends issues throughout the years. The first problem is the availability of a uniform source of financial data on a mainly privately-held industry. Although there are many more large publicly-held brokerage firms today than a decade ago, stockholder-owned brokerages still only number a few dozen out of the thousands of registered broker-dealers.

Chart A-1

NYSE GROUP'S SHARE OF TOTAL INDUSTRY*
(In Percent)

Item	**1980**	**1981**	**1982**	**1983**	**1984**	**1985**	**1986**	**1987**
Revenues	80	81	81	80	79	77	78	77
Assets	85	78	86	86	88	87	87	85
Capital	65	66	70	71	71	71	71	76
Equity	63	65	69	69	68	68	69	72
# of Firms								
NYSE Group	389	390	387	412	393	381	417	395
All Firms	5,283	5,714	6,165	7,374	8,272	8,957	9,436	9,196

* Total industry based on data from the SEC Monthly Statistical Review, August 1988.
NYSE Group: New York Stock Exchange member firms doing a public business.

The only uniform source of financial data on the securities industry is the FOCUS Report, including income statements and balance sheets, which the SEC requires all broker-dealers to file. Unfortunately, the SEC no longer publishes FOCUS information on the securities industry. SIA and the New York Stock Exchange jointly maintain a database on the quarterly performance of NYSE member firms doing a public business based on aggregate information from this group's FOCUS reporting to the NYSE. As Chart A-1 indicates, through 1987 (last reported year before the SEC discontinued FOCUS publishing), this NYSE group, although small in number, accounted for a majority of the securities business and have been a sufficiently representative group to be used as a proxy for the "total industry." In fact, there currently exists no viable alternative to this "Securities Industry Database."*

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* The "Securities Industry Database" contains quarterly and annual income statements and balance sheets from 1980 to the present on aggregate groups of NYSE member firms including, National Full Line Firms, Large Investment Banks, Regional Firms, Discounters, etc., and is available on a subscription basis from SIA's Research Department: (212) 608-1500.

Another problem with FOCUS Reporting is that its categoric breakdown of data was designed in the 1970s which no longer meets the realities of the 1980s. It will surely become hopelessly meaningless during the 1990s. For instance, 40% of the "industry's" revenues in 1989 met none of the main FOCUS reporting categories and were designated as "other revenue," either other related to the securities business or other unrelated. The problem is worse for certain firms such as Large Investment Banks where these "other" categories account for 59% of total revenue (Chart A-2). For any meaningful analysis, FOCUS could sorely use reporting lines for many of today's important businesses such as M&A fees, bridge loans, net interest or even gross interest income, private placement fees, etc.

Chart A-2

"Other" Revenue's Share of Total Revenue*
(In Percent)

Firm Category	**1980**	**1989**
National Full Line Firms	9.5	21.4
Large Investment Banks	24.3	59.0
Regionals	9.2	17.2
New York City Based	17.3	53.9
Discounters	17.3	31.1
Total Industry*	**14.5**	**39.5**

*Includes both "other related" and "other unrelated" revenue lines.

A third problem is that for those firms for which we are able to obtain data, the NYSE group, we must rely on FOCUS data which only covers the domestic broker-dealer units of securities firms. For the vast majority of brokerages, i.e. the smaller regional firm, this is not a major problem since the broker-dealer is, in most cases, the entire securities firm. However, the securities industry is dominated by large, national firms and investment banks (Chart A-3) where the broker-dealer accounts for only a fraction of the holding company's business.

Chart A-3

SECURITIES INDUSTRY* CONCENTRATION
(In Percent)

Total Revenues	**1980**	**1981**	**1982**	**1983**	**1984**	**1985**	**1986**	**1987**	**1988**	**1989**
Top 10	52.9	55.5	57.4	54.3	58.8	57.5	57.3	54.5	54.0	58.5
Top 11-25	20.1	19.5	18.7	19.6	17.1	19.7	19.8	20.9	20.8	19.3
Rest of Industry	27.0	25.0	23.9	26.1	24.1	22.8	22.9	24.6	25.2	22.2
	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Revenues ($ Bils.)	16.0	19.8	23.2	29.6	31.2	38.6	50.1	50.8	51.8	59.5

Total Capital	**1980**	**1981**	**1982**	**1983**	**1984**	**1985**	**1986**	**1987**	**1988**	**1989**
Top 10	50.7	52.6	54.8	52.9	57.3	63.2	61.9	58.3	57.5	61.8
Top 11-25	18.8	19.6	19.0	18.8	15.7	14.8	16.0	18.5	17.8	16.4
Rest of Industry	30.5	27.8	26.2	28.3	27.0	22.0	22.1	23.2	24.7	21.8
	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Capital ($ Bils.)	6.7	8.1	10.7	14.2	16.7	21.9	29.8	35.8	39.1	39.3

* NYSE member firms doing a public business

Some holding company businesses do not directly relate to securities — i.e., real estate, mortgage banking, leasing and insurance — but a good portion of holding company non-FOCUS revenues are securities related such as M&A-related, asset management, and overseas securities activities.

For the publicly held NFLs, 51% of their holding company revenues are not reported in FOCUS, up dramatically from 35% as recently as 1985. A smaller, but still large, 38% of publicly held LIBs' revenues are also not reflected in FOCUS, up from 34% in 1985.

Since these two groups collectively account for over two-thirds of all NYSE FOCUS revenues, the magnitude of the amounts escaping industry analysis is quite obvious. Further, though most small regionals have almost all of their operations within the broker-dealer, analysis of some larger, publicly held regionals' holding companies vs. FOCUS indicates that about 10% of all other firms' revenues are also not reflected in industry FOCUS analysis. The net result is an industry average of 40% of all revenues not shown in FOCUS.

Profitability levels are even more skewed by FOCUS. The NFL group's FOCUS showed losses for the past three years while their holding companies have consistently shown profits. Further holding company analysis illustrates the large difference in revenues and profits between the securities firm holding companies and their broker-dealer units (Chart A-4).

Chart A-4

NYSE Broker-Dealer 1988-89 FOCUS Reporting vs. Estimated Holding Company Total Results

(In $ Millions)

	1988		1989	
	FOCUS	Estimate	FOCUS	Estimate
NFLs				
Revenues	20,167	41,157	20,467	41,769
Pre-Tax Profits	-68	1,733	-25	376
Profit Margin	-0.3%	4.2%	-0.1%	0.9%
LIBs				
Revenues	17,049	27,498	19,410	31,306
Pre-Tax Profits	1,433	3,178	748	2,630
Profit Margin	8.4%	11.6%	3.9%	8.4%
All NYSE Firms				
Revenues	51,829	84,895	59,537	99,228
Pre-Tax Profits	2,492	6,161	1,842	4,250
Profit Margin	4.8%	7.3%	3.1%	4.3%

Despite these shortcomings, FOCUS data remains the only viable source for securities industry profitability analysis. However, the reader should keep in mind that Trends analysis of securities industry profitability refers only to NYSE member firm broker-dealers.

VOLUME

	APR. 1990	YTD 1990	APR. 1989	YTD 1989	% CHG YTD 1990-1989
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	140.1	154.5	161.9	164.7	-6.2%
AMEX (MILS.)*	14.1	14.4	11.5	11.4	26.9%
NASDAQ (MILS.)*	129.6	131.8	133.3	131.7	0.0%
REGIONAL EXCHANGE (MILS.)*	22.7	24.9	25.8	26.3	-5.4%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$95,756	$443,627	$115,480	$474,978	-6.6%
AMEX (MILS.)	3,403	13,855	3,605	12,508	10.8%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	8,644	37,076	9,644	35,477	4.5%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	12,851	56,853	16,265	66,602	-14.6%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	49.4%	49.8%	52.0%	52.6%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	9,486	41,896	9,644	41,842	0.1%
AMEX OPTIONS	2,656	12,353	3,305	13,310	-7.2%
COMMODITY	20,838	93,074	21,902	88,366	5.3%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

PRICES
(END OF MONTH)

	APR. 1990	APR. 1989	% CHG APR. 1990-1989
DOW JONES INDUSTRIALS	2656.76	2418.80	9.84%
STANDARD & POOR'S 500	330.80	309.64	6.83%
NYSE COMPOSITE	181.49	173.13	4.83%
AMEX MARKET VALUE INDEX	343.10	345.08	-0.57%
VALUE LINE COMPOSITE	232.24	254.58	-8.78%
NASDAQ COMPOSITE	420.07	427.55	-1.75%

YIELDS
(MONTHLY AVERAGES)

	APR. 1990	APR. 1989	BASIS POINT CHG 1990-1989
BOND BUYER INDEX (20 BOND)	7.39%	7.49%	(10)
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	9.45	9.79	(34)
Baa CORPORATE	10.29	10.61	(32)
RATIO Aaa CORPS. TO Baa CORPS.	0.92	0.92	0

UNDERWRITING

	FIRST QUARTER 1990	FIRST QUARTER 1989	% CHANGE 1990-1989
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$78,918.2	$72,373.0	9.0%
Common Stock	$7,125.6	$3,899.5	82.7%
# of Common Stock Issues	114	68	67.6%
Preferred Stock	$1,314.8	$559.3	135.1%
# of Preferred Stock Issues	23	13	76.9%
Corporate Debt	$70,477.8	$67,914.2	3.8%
# of Corporate Debt Issues	1275	850	50.0%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$15,538.1	$18,134.9	-14.3%
# of Issues	661	967	-31.6%
Competitive	$7,825.1	$6,558.2	19.3%
# of Issues	774	772	0.3%

Source: IDD Information Services Inc.

A8825-1

SIA
SECURITIES INDUSTRY ASSOCIATION

TRENDS

An Analysis of Emerging Trends in the Securities Industry

Produced by the SIA Research Department

Vol. XVI, No. 5 August 22, 1990

Securities Transactions Excise Tax: Wrong Tax, Wrong Time, Wrong Place

Highlights

1. *The Tax*

   Excise taxes are generally associated with products that policymakers want to curtail the consumption of. Investment in our capital markets fuels economic growth and is an activity to be encouraged not discouraged. An excise tax, or any other type of tax, on securities investment is bad policy.

2. *Who Pays?*

   In the case of equities, well over 180 million direct and indirect shareholders, reflecting all income classes. The STET is not a progressive tax on the wealthy, but a tax that falls heavily on pensioners and mutual fund shareholders.

3. *How Much?*

   Retail transaction costs would increase 25%-33%, while institutional costs would jump by three times.

4. *What's the Effect?*

   Estimates place the decline in stock prices at about 8% and the yield increase in non-Treasury debt at about 20 basis points. Stock market volume could decline between 8% and 12%. There is no guarantee that volatility will decrease because of a STET.

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5. *Bucking the Trend*

Of 15 countries surveyed (12 EC countries, Canada, Japan, U.S.), five have either lowered the rates of their taxes recently or are eliminating the tax. Six countries do not have transfer taxes. Only four countries have not perceived the need to respond to global competition.

6. *The Bottom Line*

Investor reactions will erode the government's overly optimistic estimate of tax revenues from a STET as trading activity declines and shifts to other markets.

7. *Conclusion*

Given both the current state of the economy and the low savings rate in the U.S., a STET is one of the poorest public policy choices available among tax alternatives as it negatively impacts savings channeled to our capital markets.

Securities Transactions Excise Tax: Wrong Tax, Wrong Time, Wrong Place

Introduction

After three months of meetings and negotiations, the budget "summiteers" have hammered out only the broad outlines of a budget agreement. When they return from the August recess, the summiteers will begin to put together a fiscal 1991 package that may include $50 billion in deficit reductions -- more than double the highest amount of deficit reduction Congress has ever been able to achieve in a single year -- and at least $500 billion over the next five years. A daunting task indeed, with the budget deficit coming in at $152 billion in 1989 and projected to be $195 billion in 1990 and $232 billion in 1991 (includes Resolution Trust Corporation).

While no solid budget plan has been put forth, a tentative Republican package reportedly designed by Richard Darman, Director of the Office of Management and Budget, has gained much attention. The $55 billion package, which is roughly divided between revenue increases and spending cuts, includes a limit on the deductibility of state and local taxes and increased excise taxes on beer and wine. Notably absent from the details of the plan that became public was the securities transactions excise tax (STET), a revenue raiser which was openly discussed in early July.

The securities industry and investors hope that a STET will not be included in any revenue proposals for the fiscal 1991 budget, or any other budget. In Mr. Darman's own words: "A stock transfer tax has no evident justification. It could cause distortions in the financial markets and could cause many investors, particularly institutions, to shift their equity trading away from the organized exchanges and to foreign countries."1/ Importantly, events of early August warn that our markets as well as economy are very fragile. Given both the state of the economy and the low rate of U.S. savings, a STET is one of the poorest public policy choices among tax alternatives as it impacts savings channelled to important segments of the U.S. capital markets.

Note: This *Trends* issue is based largely on material prepared this summer by SIA's Research Department on the STET.

1/ Statement before the Government Affairs Committee, January 1989.

The Tax. Not A New Idea.

The Revenue Act of 1918 first imposed a stamp tax on the issuance and transfer of certain securities, and it was not until the Excise Tax Reduction Act of 1965 that the last remnants of this tax were repealed. The Johnson Administration noted at the time that the reduction and elimination of various excise taxes, including the stamp tax, was designed to promote further economic expansion.

Speaker Jim Wright resurrected a 0.5% STET on purchases and sales in 1987 and a variation thereof has been included every year since by the Congressional Budget Office (CBO) in its annual list of revenue-raising options. Based on the CBO proposal, a 0.5% STET on the sale of most securities (with the notable exception of Treasuries) would raise some $7.8 billion in the first year, $11.6 billion in the second, and $57.7 billion over five years (SIA always had doubts about these estimates). Along with its revenue-generating potential, the tax appeals to those policymakers who are concerned about market volatility and the short-term focus of Corporate America (supposedly engendered by money managers with short-term horizons). However, a STET applying to both long- and short-term transactions does not appear to be an efficient way of resolving this particular problem.

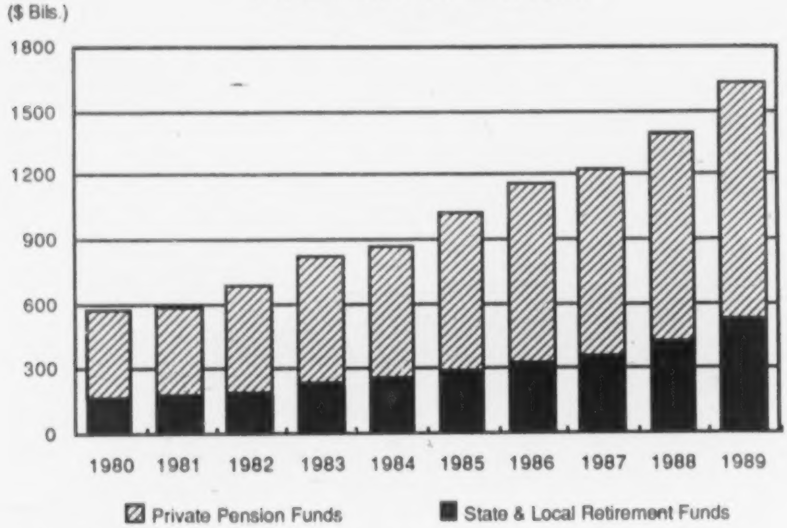
Excise taxes in the U.S. are generally associated with certain products that policymakers deem desirable to curtail. For example, the excise taxes on tobacco and liquor are often referred to as "sin taxes." Investment in our capital markets, however, fuels economic growth, an activity that public policy should obviously encourage. Thus, it is difficult to understand how a transactions tax can be seriously considered as a viable policy option given the "punishment" concept embodied in excise taxes.

Who Pays? All Savers.

Generally, the higher an individual's income, the more disposable income to save and invest, and the larger the value of securities holdings. Hence, the STET is viewed as more progressive than other excise taxes. The STET, however, is not just a tax on "fat cats," it is a tax that hits those individuals who have their savings invested through pension funds, insurance companies and mutual funds. Unlike many other nations, equity ownership in the U.S. is broad-based. Millions of individuals own stock -- directly and indirectly. Individuals or households directly own 56.3% of corporate stock outstanding, while institutional and other investors hold 43.7%. More critical, within the institutional investor category are the pooled savings and retirement funds of individuals whose future income is directly affected by the performance of investments and the associated costs, such as a STET.

Total financial assets less government securities of state and local and private pension funds rose from $577 billion in 1980 to $1,629 billion by year-end 1989. Since the tax being discussed covers more than equities, we believe the amount of funds raised from these intermediaries far exceeds the government estimates released so far. For example, if we assume a conservative turnover rate of just 40%, the $1.6 trillion in assets would generate $32 billion alone annually given a STET of 0.5%. Given the broad participation and population distribution of pension plans, a STET strikes pension plans representing the retirement income of millions of individuals of modest income.

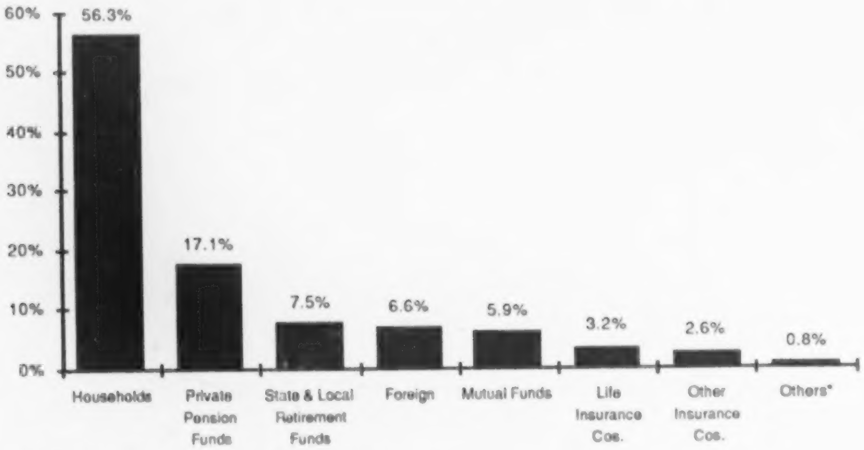
HOLDINGS OF PRIVATE PENSION AND GOVERNMENT RETIREMENT FUNDS



Note: Data excludes holdings of government issues

Private pension funds combined with state and local retirement funds hold almost 25% of total equities outstanding. As assets of these funds ballooned in the 1980s, equities became a weightier component of the portfolios of these funds. State and local retirement funds, in particular, increased investment in equities in the 1980s, with holdings escalating from $44.3 billion in 1980 to $280.1 billion by 1989. When individual shareholders are combined with private and public pension funds, individuals hold over 80% of equities outstanding. These direct and indirect stockholders -- well over 180 million individuals -- reflect all income classes, running the gamut from modest to top income earners.

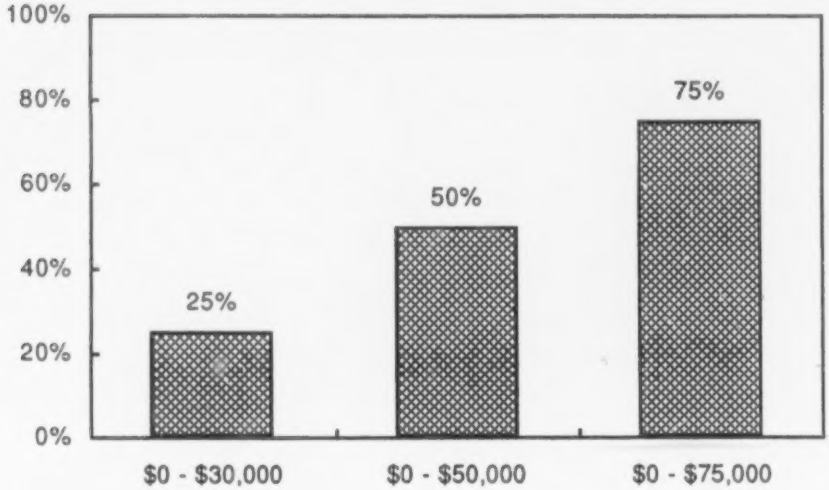
HOLDINGS OF U.S. EQUITIES
First Quarter 1990



*Commercial & mutual savings banks; broker-dealers.

The distribution of pension fund assets in 1990, based on estimates prepared for Merrill Lynch of the accrued levels of pension benefits for a representative group of pension plan participants, underscores the regressive nature of a STET.[2] Almost 25% of all accrued benefits (assets) are held by persons with family income less than $30,000. Almost half of all assets are held by persons with family incomes of less than $50,000, and almost 75% of all assets are held by persons with family incomes of less than $75,000. In 1988, over 78 million individuals participated in pension plans and over 72 million individuals had a vested right to receive benefits from at least one retirement plan. Pension plan participation has little to do with income or age -- 85% of pension plan participants had income under $50,000; about 46% of all individuals over age 20 participate in pension plans.

DISTRIBUTION OF PENSION FUND ASSETS
BY FAMILY INCOME



A STET would hit pension plans and other institutions holding substantial assets on behalf of individuals. Estimates indicate that institutions account for about 75% of trading on the NYSE, hence a transfer tax would raise most of its receipts from institutional investors and not individual shareholders. Given the broad participation and population distribution of pension plans, a STET would strike pension plans holding billions of dollars in assets for individuals of modest income. This is not the result policymakers had in mind when they first proposed a STET "aimed at the rich".

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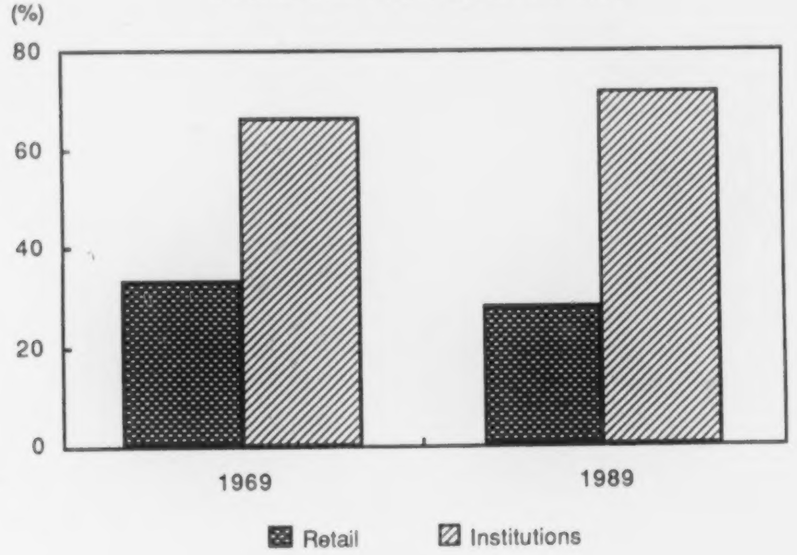
[2] Unpublished research of Health & Sciences International Incorporated, commissioned by Merrill Lynch, August 1, 1990.

DISTRIBUTION OF TRADING BETWEEN INDIVIDUALS AND PROFESSIONALS



To the extent that a STET reduces the earnings of defined pension funds, corporations will have to pick up the slack. While these plans reportedly took back almost $19 billion in the 1980s as pension funds performed well, the monies returned most likely became reportable as corporate profits, enhancing both the corporation's stock price and Treasury tax revenues. For undefined plans, the STET will reduce benefits paid to retirees. For public pension funds, reduced investment earnings may require more tax dollars for increased public employer contributions.

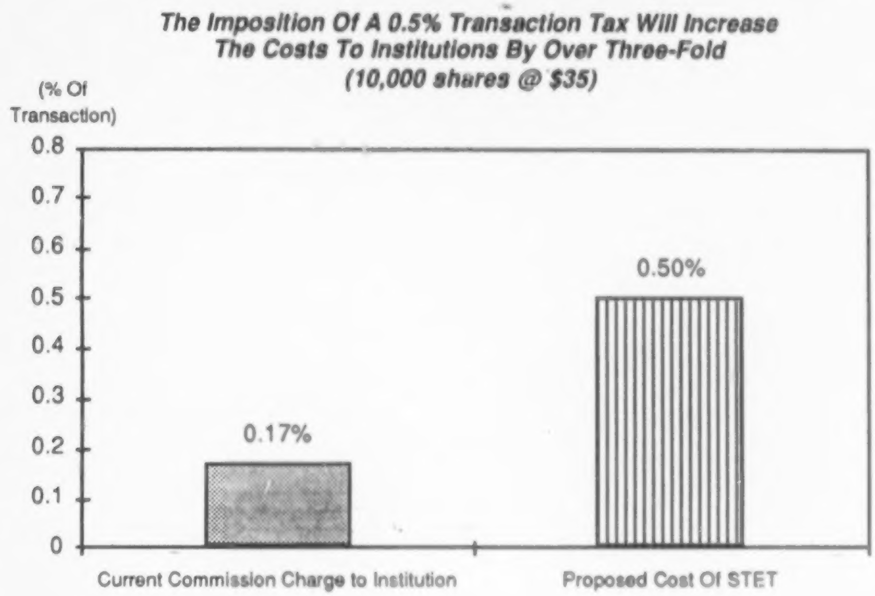
Of note, a STET on the sale of securities is a tax on the winner -- and the loser. Those individual investors with capital losses are already limited to only a $3,000 loss offset against ordinary income. A STET could prove to be very discouraging to the common stock investor in particular. Common stock investment is already the highest taxed of capital investment, given the double tax on dividend income and the elimination of any capital gains differential.

How Much? More Than You Think.

Any tax of 0.5% appears minimal at first blush. However, when applied to share transactions, the STET represents a significant increase in the cost of trading. For retail investors, the average commission varies between 1.5%-2.0% of the value of the order. On a 100 share order at $35, the STET would increase retail investment costs by 25%-33%. For institutional investors whose commissions range between 5¢-6¢ per share, a STET would increase transaction costs by three times.

Reducing the size of a STET may make it somewhat less onerous, but the impact still remains significant, particularly for institutional investors. For example, a 0.1%

STET would increase institutional trading costs by about 50% At a time when the U.S. is worried about low levels of savings and capital investment, any detriment to investment, even a seemingly small 0.1% tax, is counterproductive.



The Imposition Of A 0.5% Transaction Tax Will Increase The Costs To Institutions By Over Three-Fold (10,000 shares @ $35)

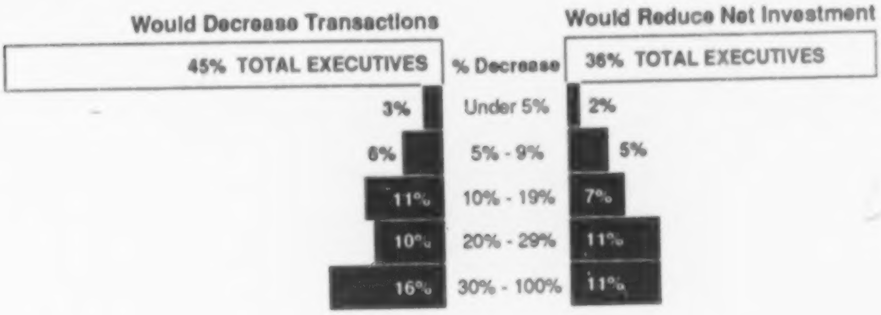
What's The Effect? Detrimental.

On the market...Any tax on securities investment reduces the return on that investment. A STET would tend to depress securities prices, as investors take into account the added tax burden. For short-term investment, where the spread is typically narrow, the tax could exceed the spread, thereby preventing the trade. Even for assets held longer, the STET would amount to a surcharge on earnings.

There have been several attempts to quantify the impact of a STET on securities prices. In May 1987, the Joint Committee on Taxation estimated a 0.5% STET on the purchase of corporate stock could cause stock prices to decline between 2% to 10%. More recently, a Goldman Sachs study shows that a STET could lower share prices by about 8%. In addition, a Congressional Research Service study puts its estimate of a 7.7% decrease in stock prices into perspective -- a STET would imply a drop of more than 220 points given a DJIA of about 2900.

The effect of a STET on the fixed-income markets is no less discouraging. The Public Securities Association notes that the discussed range of a STET would exceed, in many cases, the bid-offer spread prevailing in the fixed-income markets. Interestingly, in the government market (which would be exempted), a STET of either 0.5% or 0.15% would essentially halt trading. Merrill Lynch Capital Markets estimates a 0.5% tax on non-Treasury debt would cause a 20 basis points increase in yield and a 0.15% tax, a 5-10 basis points increase.

A recent survey by SIA and Opinion Research Corporation asked *executives* (500 in sample) what their reaction would be to a STET on the purchase and sale of common stock.3/ To the best of our knowledge, this represents the first poll of investors as to their reaction to a STET. While the poll cannot be extrapolated to the general population, their response lends credence to the adverse impact of a STET on both securities prices and volume. Forty-five percent of the executives said they would decrease their stock market transactions by an average of 27.5%. About 36% of the executives stated they would reduce their net investment in common stock, with the mean reduction 26.2%. The STET on common stock would send investors looking for other investment vehicles. More than half of the executives polled stated they would shift common stock investment dollars to alternative investments. The bottom line: a STET would reduce investments in taxed assets and lower the number of transactions.



Of special note, the exemption of Treasury securities from a STET is a somewhat obvious admission of the negative impact this tax would have. The STET, by lowering securities prices will, in effect, raise the cost of capital for all issuers -- except government. The U.S. already fares poorly in terms of capital costs compared to other nations.

The significant increase in transaction costs wrought by a STET will lead to a decrease in trading volume as investors "lock-in" or seek lower cost markets. For the individual investor, the STET is another added burden on the return from investment. Similar to the "last straw," investors could choose not to sell or to "lock-in." Assume the purchase of 100 shares of stock at an average price of $35. A $5 increase in the stock price represents a 14.3% gain and a $10 increase, a hefty gain of 28.6%. However, the net return to the investor after commissions (1.5% of value), a capital gains tax (top rate, 33%), and the STET (0.5%) is a far cry from the initial price gain. These factors combine to whittle away the investor's return to 6.3 % in the first example and 15.7% in the second (excluding dividends and inflation). No wonder many investors are seeking safe, conservative investments.

In the case of institutional investors, the U.S. currently is tied with Canada in offering the lowest institutional transaction costs based on a comparison of the major

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3/ *Executives' Investment Reactions to Tax Proposals Affecting Savings & Investments*, SIA, July 1990.

equities markets -- U.S., Canada, Japan and the U.K.[4] The STET (averaging 0.5% on both sides of trade) would move the U.S. to the highest cost market for large institutional trades and to the second highest for small transactions. Even if a STET of 0.1% were placed on only the sell side, the U.S. would still rank as the second highest cost market. A transaction cost escalation of this magnitude will surely send institutional investors "shopping" for lower cost markets, i.e. foreign markets. It seems irrational that in an era of intensifying global competitiveness, the U.S. would jeopardize the preeminent position of its capital markets.

Even if as proponents of the STET claim, the tax would not send domestic transactions to other shores, foreign investors would be "shopping" for lower cost markets. Worldwide events in the 1990s -- an integrated European common market and Eastern Europe -- already present foreign investors with new investment opportunities and commitments. Building competition for capital has the potential to lessen the capital support foreign investors give to the U.S. equities markets in general. And, that support is significant -- in 1989, foreign gross activity in U.S. securities topped $4 trillion and net purchases neared $100 billion.

STET supporters argue that the STET diverts trading to other markets, the U.S. should have a monopoly in trading all securities. However, the trading of foreign securities in the U.S. is no simple matter. Many U.S. institutions are precluded from purchasing foreign securities that are not listed on a major U.S. exchange. To obtain such a listing requires disclosure and accounting standards that many foreign companies have been unwilling to adopt.

Foreign investors account for about 10% to 12% of the value of current trading in the U.S. equity market alone. With the STET discouraging both domestic and foreign trading, the value of trading could well fall more than 12% or 38 million shares per day based on first-half 1990 volume. By the way, the Congressional Research Service estimates a 7.9% decline in volume.

On market characteristics...Given its impact on stock prices and stock volume, the STET has ramifications for market characteristics. Reduced trading volume suggests that market liquidity -- the ability to buy and sell a security at a fair price when you want -- will be reduced. Proponents of a STET claim that reduced short-term trading would be beneficial, as it would most likely reduce volatility. The question of whether or not the stock market is more volatile today than in the past should be answered, as volatility is one of the driving forces behind a STET. Certainly there have been some very volatile days, with October 19, 1987 the most volatile day in a ranking of the Top 100 largest Dow percentage movements. Five other days during the 1980s also are on the Top 100 list, including recovery days following the crash. However, 94 of the Dow's most volatile days (in percentage terms) came before 1980 and, except for the six days in the 1980s, the Dow moved less than 5% per day in any given day in the decade.

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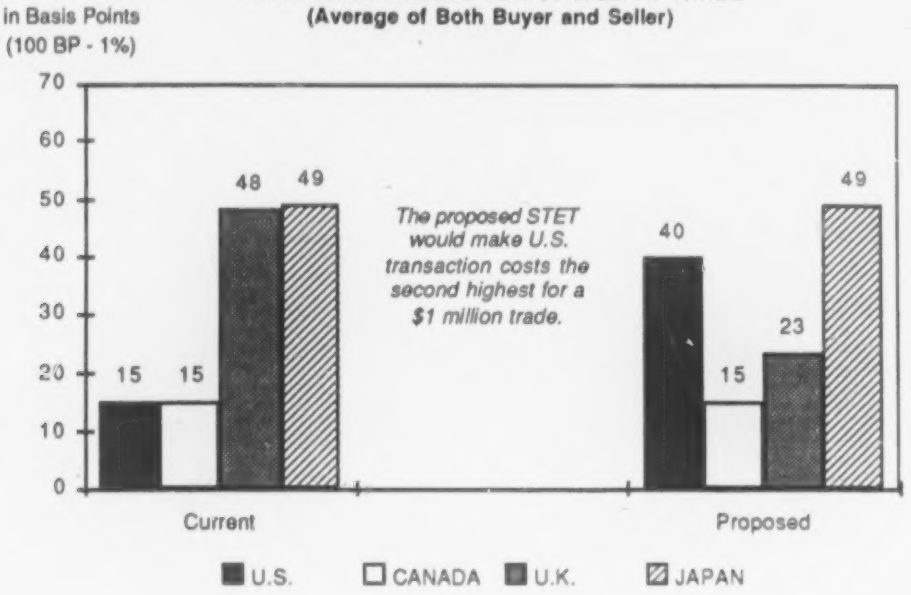
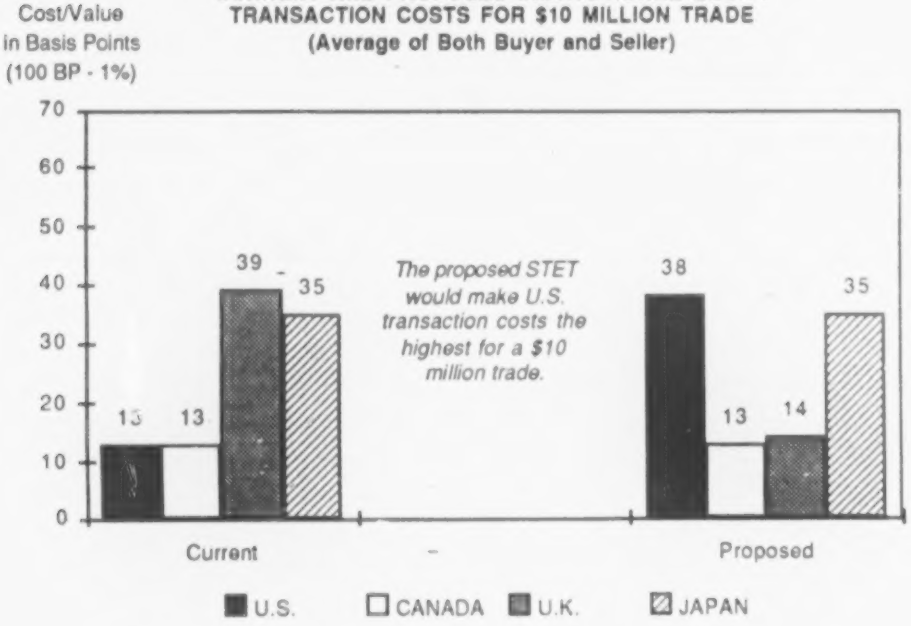
[4] See *Institutional Equity Transaction Costs -- Effects on Costs by Current & Proposed STETs by Major Nations,* SIA Research Department, August 8, 1990.

CURRENT AND PROPOSED INSTITUTIONAL EQUITY TRANSACTION COSTS FOR $1 MILLION TRADE (Average of Both Buyer and Seller)



The proposed STET would make U.S. transaction costs the second highest for a $1 million trade.

CURRENT AND PROPOSED INSTITUTIONAL EQUITY TRANSACTION COSTS FOR $10 MILLION TRADE (Average of Both Buyer and Seller)



The proposed STET would make U.S. transaction costs the highest for a $10 million trade.

Note: Current U.K. Stamp Tax and Japan STET averaged half each to both buyer and seller. Proposed 0.5% U.S. STET averaged half each to both buyer and seller; scheduled elimination of U.K. Stamp Tax.

It is the perception of volatility that has changed in the 1980s, not the reality. The focus has always been on point swings in the Dow instead of the percentage change. A 100 point move in the Dow eight years ago would have been a 13% change, today it is about 3%. There is a big difference between a Dow of almost 800 and almost 3000.

Reducing the number of buyers and sellers for any given security makes that particular security less liquid. This creates the potential for volatility as the trading range will be larger and the market impact of transactions will increase. The STET may well reduce volume and liquidity but not necessarily volatility.

A heightened volume level is also sometimes associated with volatility. Fears of market volatility should also have been eased by the dampened volume levels of recent years. When the STET was first proposed in 1987, volume averaged 189 million shares daily on the NYSE. Volume dropped 14% in 1988 and recovered a modest 2% in 1989. Through June of this year, volume has averaged 155.5 million shares -- almost 18% below the 1987 level. Moreover, there is no direct evidence that a STET would reduce market volatility.5/ The October 1987 crash seemed to be no less severe in foreign countries, despite the existence of transfer taxes.

While the STET has some distinct undesirable effects on the financial markets, those effects hold implications for the general economy. Based on a study by Merrill Lynch Capital Markets, a 0.5% tax on the sale of non-Treasury securities would result in a 5% drop in stock prices and an initial 20 basis point increase in yields on non-Treasury debt.6/ Under these assumptions, GNP growth would be about 0.5% less after one year and would be lower by a additional 0.4% after two years than might otherwise have been the case. Indeed, it is estimated that these declines would offset the benefit to the Federal deficit that would result from the tax after one year and would actually increase the deficit after two years.

Bucking The International Trend

In mid-1987, the European Commission unveiled a plan to eliminate taxes on securities transactions throughout the European Community (EC).7/ This proposal is part of the Commission's drive to create a barrier-free market for goods and services by 1992. The Commission's initial proposal, released in 1976, called for the harmonization of transaction taxes rather than abolition of the tax because of revenue considerations. However, the Commission recognized that "the most desirable solution, from the point of view of the establishment of a real European capital market,

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5/ *Reducing the Deficit: Spending and Revenue Options,* Congressional Budget Office Report, February 14, 1990.

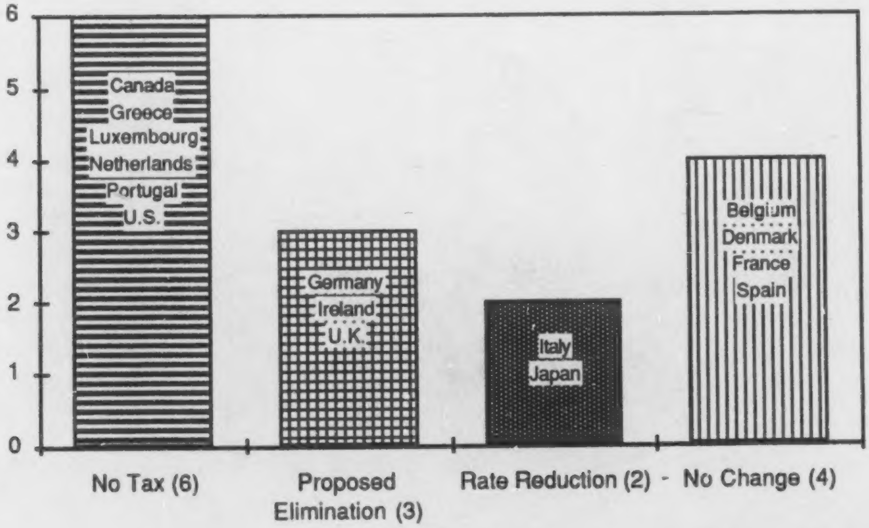
6/ *Economic Consequences of a Securities Transfer Tax,* Merrill Lynch Capital Markets Global Securities Research & Economics Group, July 1990.

7/ *A Comparison of Trends on Securities Transaction Taxes: The U.S. and Its Major Competitors,* J. Schaefer and D. Strongin, SIA, July 25, 1990.

would be the abolition, purely and simply, of these taxes." While this proposal is still under consideration, there is an independent movement under way in many countries to eliminate or reduce the rate of transfer taxes for competitive purposes.

Of 15 countries surveyed, (12 EC countries, Canada, Japan, U.S.) five of these countries have either lowered the rates of such taxes recently or are in the process of eliminating the tax entirely. Moreover, six of the countries do not have a transfer tax. Most recently, the Netherlands abolished the tax as of July 1990.

Securities Transaction Tax Trends In Fifteen Countries



The following three nations are in the process of eliminating the tax--Germany, Ireland, and the United Kingdom. All of these nations are planning to eliminate the transfer tax by late 1991. In announcing the proposal to abolish all stamp duties on transactions in shares, the U.K. Chancellor commented that abolition of these duties will: 1. enhance London's competitiveness as an international center for equity trading and, 2. boost wider shareownership by reducing transaction costs and benefit savers.8/ Two countries - Italy and Japan - recently lowered their transfer taxes. Only four countries, Belgium, Denmark, France, and Spain have not as yet recognized the increased global competitiveness of the world's securities markets.

Canada, Greece, Luxembourg, the Netherlands, Portugal and the U.S. do not have a transaction tax. Neither Canada nor the U.S. have transaction taxes and are distinct from the other countries. Given the number of interlisted securities on these two markets (180), the consideration of a transfer tax by one country and not the other

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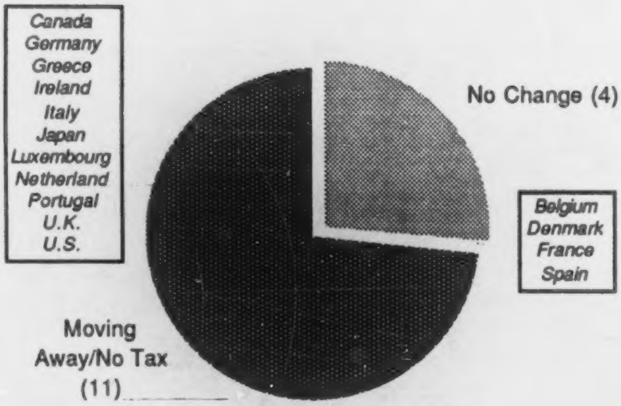
8/ *Stamp Duty on Shares to be Abolished*, Inland Revenue Press Release, March 20, 1990.

would have major competitive implications. Moreover, there is a history of parallel movement in regulation or deregulation between Canada and the U.S. The competitive threat of losing transactions to the U.S. when fixed commissions were abolished, in part, led to the elimination of Canadian fixed commission rates. Canada appears to be strongly opposed to transfer taxes. Not only does Canada currently not have such a tax, but securities will remain exempt from the 7% goods and services tax scheduled to take effect January 1, 1991.

A Majority Of Countries Are Moving Away From The Transfer Tax



Clearly, the imposition of a STET in the U.S. would be inconsistent with and counter to the international trend. Our foreign competitors would like nothing more than for the U.S. to proceed with adoption of a securities transaction tax. The largest foreign markets are well aware that U.S. institutions can trade through London or other financial centers in the many internationally-traded U.S. issues. Indeed, the July 9 *Financial Times* reported: If the Administration decides to go ahead with the securities turnover tax, it will have strong support in the City of London.

The Bottom Line. A Disappointed Treasury.

The CBO estimates that a STET would generate revenues of $11.5 billion annually, on average. Given the aforementioned considerations, this estimate is very optimistic. The effect of investor reaction -- individual, institutional, and foreign -- will reduce share volume and prices, thereby eroding government's tax take. In this sense, the STET is indeed an excise tax as it will curb the demand for securities investment.

Put into another perspective, the government estimate places revenues from a STET at more than the commission revenues generated by the entire NYSE membership in 1989 or 1988. A revenue estimate which is larger than the entire revenues of the industry supplying the service is, questionable. Moreover, given the nature of the securities business, the revenue raised by a securities transactions tax would probably be more "volatile" over time than most other tax revenue sources. To provide a recent example, the total dollar value of trading on the New York Stock Exchange (NYSE) increased by 36 percent in 1987, decreased by 28 percent in 1988, and rose by 14 percent in 1989.[9] In overall terms, the 1980s have been very active times for the financial markets, both in the U.S. and abroad. A recession, however, particularly a deep recession, could reduce both prices and trading volume significantly, thereby reducing revenues from a transactions tax.

Conclusion

When policymakers once again turn to the tough job of putting together a fiscal 1991 budget, the STET may very well come up for discussion again. While there are many permutations of the basic STET concept, there are none which would make this, or any other tax on securities investment, good public policy. The case against the STET is a strong one. It is a tax on all investors in our capital markets that will be borne by retirees, mutual fund investors, state and local employees, corporations, etc. The damage that could be done to investors and our financial markets far outweigh questionable revenue estimates. The government must look elsewhere for its revenue requirements. A STET would be the wrong tax, at the wrong time, on the wrong activity. Let us all recognize how dramatically conditions and the markets have changed since the 1987 crash.

Jeffrey M. Schaefer, Senior Vice President &
Director of Research

Carolyn Hildebrandt, Assistant Vice President &
Director of Macroeconomic Studies

George R. Monahan, Director of Industry Studies

David G. Strongin, Director, International Finance

Grace Toto, Research Assistant

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[9] *The Securities Transactions Tax: An Overview of the Issues*, Donald W. Keifer, Congressional Research Service, July 25, 1990.

VOLUME

	JUNE 1990	YTD 1990	JUNE 1989	YTD 1989	% CHG YTD 1990-1989
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	153.6	155.8	180.3	168.2	-7.4%
AMEX (MILS.)*	12.4	14.0	13.5	11.7	19.3%
NASDAQ (MILS.)*	149.7	139.1	137.7	134.1	3.8%
REGIONAL EXCHANGE (MILS.)*	24.3	24.9	26.7	26.6	-6.3%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$115,622	$687,021	$152,058	$763,416	-10.0%
AMEX (MILS.)	3,169	20,230	4,762	20,690	-2.2%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	11,141	59,047	10,678	57,644	2.4%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	14,834	87,436	18,063	102,884	-15.0%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	49.9%	50.1%	53.1%	52.6%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	10,745	64,443	11,799	65,140	-1.1%
AMEX OPTIONS	2,544	17,947	3,492	20,366	-11.9%
COMMODITY	22,004	139,740	27,415	140,162	-0.3%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

PRICES
(END OF MONTH)

	JUNE 1990	JUNE 1989	% CHG JUNE 1990-1989
DOW JONES INDUSTRIALS	2880.69	2440.06	18.06%
STANDARD & POOR'S 500	358.02	317.98	12.59%
NYSE COMPOSITE	195.48	177.90	9.88%
AMEX MARKET VALUE INDEX	361.21	358.97	0.62%
VALUE LINE COMPOSITE	245.97	259.86	-5.35%
NASDAQ COMPOSITE	462.29	435.29	6.20%

YIELDS
(MONTHLY AVERAGES)

	JUNE 1990	JUNE 1989	BASIS POINT CHG 1990-1989
BOND BUYER INDEX (20 BOND)	7.24%	7.02%	22
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	9.26	9.10	16
Baa CORPORATE	10.22	10.03	19
RATIO Aaa CORPS. TO Baa CORPS.	0.91	0.91	0

UNDERWRITING

	FIRST HALF 1990	FIRST HALF 1989	% CHANGE 1990-1989
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$163,912.6	$142,336.4	15.2%
Common Stock	$12,891.5	$8,879.5	45.2%
# of Common Stock Issues	247	187	32.1%
Preferred Stock	$2,846.3	$2,241.2	27.0%
# of Preferred Stock Issues	51	37	37.8%
Corporate Debt	$148,174.8	$131,215.7	12.9%
# of Corporate Debt Issues	663	726	-8.7%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$43,459.9	$40,312.1	7.8%
# of Issues	2,028	2,504	-19.0%
Competitive	$15,976.0	$15,124.2	5.6%
# of Issues	1,736	1,730	0.3%

Source: Securities Data Co.

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	*Description*	*Source*
Survey of Transfer Taxes	This survey examines transaction taxes in eleven major capital markets. The study indicates that while the majority of countries reviewed impose transfer taxes, an increased awareness of the growing global nature of today's markets has started a movement to eliminate this impediment to free-flowing capital markets. The survey was independently conducted by Ernst & Young for SIA.	SIA Research Deptartment 212/608-1500
Economic Consequences of a Securities Transfer Tax	This report concludes that an 0.5% tax on the sale of non-Treasury securities could result in a 5% drop in stock prices and an initial 20 basis point increase in yields on non-Treasury debt. Moreover, GNP growth would be about 0.5% less after one year and would be lower by an additional after two years than might otherwise have been the case.	Merrill Lynch Capital Markets Global Securities Research & Economics Group World Financial Center North Tower New York, NY 10281-1320
Effects of a Securities Transaction Tax on the Fixed-Income Securities Markets	This study shows the negative impact of a securities transaction excise tax on fixed-income instruments. In addition, the effect on the cash and futures markets are exposed. The fixed-income market would be particularly hard hit as the discussed range of the STET would exceed, in many cases, the bid-offer spread prevailing in the market. The results of such a tax would be increased cost of borrowing, increased volatility, lower return for investors in pension and mutual funds and less revenue to the U.S. Treasury than forecast.	Public Securities Association 1000 Vermont Ave., N.W Suite 800 Washington, DC 20005
The Case For A Securities Transaction Excise Tax	The paper lays out the theoretical and empirical arguments that excessive short-term trading in securities markets can reduce economic efficiency. The article concludes that a STET would not be harmful to the economy, and if it reduced market speculation, it could be helpful to the economy. Indeed, the tax would not discourage long-term investment. Moreover, the article notes that the tax would not drive financial markets overseas, would not make American capital markets dangerously illiquid, and would not have a significant adverse impact on equity values or unduly burden American workers.	Tax Notes 6830 No. Fairfax Drive Arlington, VA 22213 August 13, 1990

Item	*Description*	*Source*
The Securities Transaction Tax: An Overview of the Issues	This report provides an overview of the policy issues regarding a stock transfer tax. It concludes: 1) a 0.5% tax could cause trading volume to decline by about 7.9% and market prices to decline about 7.7%; 2) the tax probably would not have any significant effect on volatility; 3) the effect of the tax on the cost of capital is likely to be small; and 4) the argument that resources are wasted in the pursuit of profits in speculative trading in the financial markets has not been demonstrated in a rigorous empirical analysis.	Donald W. Kiefer Congressional Research Service The Library of Congress July 25, 1990
A Position Paper Evaluating A Securities Transaction Excise Tax In The U.S.: Domestic and International Implications	The position paper argues that a securities transaction excise tax would not only impede the efficiency of the U.S. markets, raising costs for issuers, investors and intermediaries, but would also damage the competitiveness of the U.S. capital markets on an international basis; in one of the few markets where the U.S. is still a leader.	SIA Research Department 212/608-1500
Executives' Investment Reactions to Tax Proposals Affecting Savings & Investment	A joint SIA/Opinion Research Corporation study on investor responses to various tax proposals on capital gains, double taxation of corporate earnings, and exempting interest and dividends on long-term investments. For the first time, perhaps, investors were also polled as to how a stock transaction tax would affect their investment decisions. The survey indicated that a transaction tax would cause a sizable decline in both the number of stock transactions and the amount invested in stocks.	SIA Reseach Department 212/608-1500

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SIA SECURITIES INDUSTRY ASSOCIATION

TRENDS

An Analysis of Emerging Trends in the Securities Industry

Produced by the SIA Research Department

Vol. XVI, No.6 October 15, 1990

The Forest For The Trees:
The Need For Tax Incentives To Save & Invest

1. The current economic environment and recent history argue for savings and investment incentives for all taxpayers regardless of income class. "Class warfare" by politicians over who uses a pro-growth tax incentive that accomplishes its objective should be a moot point -- all taxpayers benefit from economic growth stimulated by increased savings and investment.

2. The consequences of protracted and large federal deficits is reflected through the increasing burden of federal debt. Federal debt as a percent of GNP measured 33% in 1980, passed the 50% mark in 1986, and will escalate to an estimated 59% in 1990.

3. Despite current economic conditions, reducing the deficit by a combination of raising taxes and lowering spending may be called for -- given political realities. Large deficits are acting as a drag on the financial markets and the economy. Many individuals have lost complete confidence in the benefits of and limits to government spending. Pro-growth tax incentives are part of the prescription for what ails the economy.

4. The results of a recent SIA/Opinion Research Corporation executive survey support the historical evidence on how critical tax incentives or disincentives are in encouraging or discouraging savings and investment.

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- A reduction in the capital gains tax rate to 20% with a one-year holding period would spur 55% of the surveyed executives to increase investment in common stock, with the mean investment amounting to $20,800.

- Seventy percent of the executives said they would open 10-year savings accounts that exempted earnings as they build and when withdrawn. In terms of funds invested in the accounts, 12% of the executives indicated monies would be from shifted savings, 16% said funds would be new savings, and 41% claimed monies saved would be a combination of shifted and new savings.

- A 50% shareholder credit to alleviate the double tax on dividends would prompt 67% of the executives to make new or increased investment in common stock or common stock mutual funds.

- A 0.5% tax on the purchase or sale of common stock would cause 45% of the surveyed executives to decrease their stock transactions and 36% to reduce their net investment in common stock.

5. The major conceptual flaw in the various bills is the claim to directly or indirectly increase taxes on the "rich." There are few people that consider themselves rich because their income exceeds $100,000 or $200,000. For example, a married professional couple -- doctors, lawyers, consultants -- would hit this income mark.

6. Today, the income groups over $50,000 pay a much larger share of the income tax burden than in 1980. More than anything else, this reflects the rapid upward move in income distribution as individuals and families, benefiting from the economic growth of the 1980s, moved into higher income brackets.

7. High spending, high taxing governments have never provided the environment necessary for sustainable economic growth for their citizens.

Note: The views expressed in this paper are those of the authors and not necessarily SIA.

Single copies of the SIA/ORC study, *Executives' Investment Reactions to Tax Proposals Affecting Savings & Investment,* on which this paper is partly based are available free of charge. Additional copies available for a modest price.

Introduction

In early 1989, the federal government examined the importance of and issues related to national savings and investment, with a strong concern for the dismal U.S. position. Background materials prepared for the Administration's Economic Policy Council in 1989, and recently summarized in the Treasury Bulletin, pointed to three major economic challenges for the U.S. in the future: 1. maintaining a strong economy; 2. competing successfully in the world economy; and 3. preparing for the "demographic twist" when the retirement-age population will outnumber the working-age population. The key to addressing these challenges is improved productivity: a higher rate of national savings is a crucial component of that goal.

The need to bolster savings and investment, while not exactly forgotten, has been put on a back burner recently. This problem deserves more, not less, attention in times of budgetary dilemma, near-recessionary conditions and weak capital markets. The pressure Congress once again feels to reduce the weighty federal deficit seems to preclude consideration of meaningful savings incentives in the tax code. Indeed, the President's capital gains proposal brought the budget process to political gridlock. Either of the two opposing sets of revenue estimates for this proposal indicate a minor impact on the deficit. In the past, capital gains tax reductions have led to revenue increases.

Several changes in policy are needed to ensure stable economic growth, including savings and investment incentives. The current economic environment and recent history argue for savings and investment incentives for all taxpayers with the wherewithal to take advantage of them. If a tax incentive accomplishes its job -- stimulating savings and investment, all other concerns such as which income group uses the incentive should be a moot point. All taxpayers eventually benefit from economic growth and job creation resulting from savings and investment.

Current Economic Environment

Even before the early-August Mideast crisis, there were more than a few signs that economic growth was slumping. In broad terms, real GNP expanded at a 2.5% annual pace in 1989, dipping to a meager 0.3% in the last quarter. Economic growth picked up to a 1.7% annual rate in the first quarter, but plummeted in the second quarter to only 0.4%. Employment growth, reflecting the slowing economy, has fallen to the slowest rate since the 1982 recession. Inflation has gathered momentum during the year and was clocked at a 5.6% annual rate in August. With the Fed keeping an ever-watchful eye on inflationary pressures, interest rates have been firm despite mounting recessionary signals. Moreover, the dollar is having problems in the foreign exchange markets. With major foreign countries raising interest rates, it is questionable just how much room there would be for any easing of rates.

Major sectors of the U.S. economy are depressed. The slump in the real estate industry and the associate housing and construction sectors has intensified in 1990. Housing starts have sunk to the lowest level since the 1981-82 recession and, given the asset/liabilities problems of the banking industry and stiffer capital requirements, lenders are particularly cautious in extending credit. Chase Manhattan's announcement of 5,000 layoffs is a sad comment to the turmoil of the banking industry. The ills of the savings and loan industry in the past two years have set regulators and legislators on a long and costly path to sort them out. The days of glory of the securities industry were put to an end by the 1987 crash, with over 45,000 employees, or 17.4% of the industry's labor force, laid off since that time. While these sectors have been particularly hard hit, corporate profits have been steadily worsening. Although Iraq may have been the "trigger" calling attention to the state of the economy, many signs were already pointing to a bumpy, not soft, landing ahead.

The stock market has never fully regained investors' confidence since October 1987. Although there have been occasional hints that individual investors were returning to the market, neither individual nor institutional investors have put much "spark" into stock market performance in recent years. While stock market indices have until recently generally climbed slowly, volume levels in 1988 and 1989 were some 12%-14% below the 1987 peak. Volume in 1990 through August was depressed below even the 1988-89 levels. In August, markets twisted and turned to the tune of oil price gyrations, cumulating in a Dow give-up of almost 300 points. By the end of September, the Dow had broken below the 2500 level for a loss of almost 450 points since early August.

Large and small cap stocks moved pretty much in tandem until 1986. Since that time, with the exception of 1988, smaller capitalized companies have not enjoyed the same gains as their bigger brethren nor weathered downturns as well. Much of the focus in the second half of the 1980s was on merger and acquisition activity, with at least part of the $500 billion in equity retirement in the decade attributed to this activity. These supply factors spurred the price advance of the late 1980s. Nevertheless, after the crash, stock prices took almost two years to reclaim lost territory. The pre-crash Dow record was 2722.42 -- the 1989 close was only 1.1% above this high. Events of the past few months have sent stock prices back to below the 1989 close.

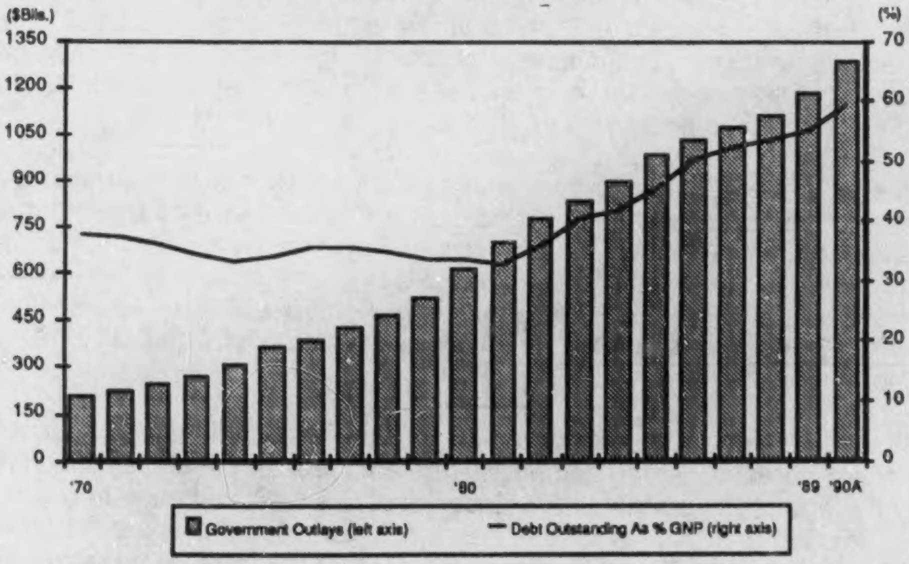
As a reflection of market fundamentals, the initial public offering market, once primarily the domain of new companies and individual investors looking for returns in the form of capital gains, has all but evaporated. Closed-end mutual funds, which invest in fixed income instruments or stocks of foreign countries, have become the major portion of the IPO market. For example, in 1988 and 1989, closed-end funds accounted for 74.4% and 55.1%, respectively, of the funds raised in the IPO market.

Adding another dimension to the picture is a building worldwide capital shortage. Between 1980-88, the U.S. was able to maintain domestic investment at almost the same level as during the 1950-79 period despite the increasing drain of government on private sector savings. A tremendous surge of foreign capital allowed the U.S. to "overspend" in the 1980s. The foreign capital supply, while probably destined for an end sooner or later, seems to be coming to an end sooner. Whether prompted by opportunities elsewhere or a weakening U.S. economic outlook, foreign investors pulled $6.8 billion from the U.S. equities market in the first six months of 1990, in contrast to net purchases of $5.0 billion in the same period in

1989. Combined with the outflow of U.S. investors who are increasingly seeking overseas portfolio diversification, the potential demand for U.S. equities was reduced by some $13 billion in the first half of the year just by global capital flows. The consequences of a sharp retreat by foreign investors and stepped-up capital outflows by U.S. investors are many, but two are higher real interest rates and lower equity prices in the U.S.

Policy Options

The federal deficit has been stuck at about $150 billion (on and off budget) for the past three fiscal years. Deficit reduction can be claimed only as a percentage of GNP and only because GNP has grown as real economic growth continued. However, the consequences of protracted deficits is captured in the increasing burden of federal debt. Federal debt as a percent of GNP measured 33.3% in 1980, passed the 50% mark in 1986, and escalated to an estimated 59% in 1990. Although a surplus is expected in the last month of the year which would reduce the total deficit, as of the first 11 months of fiscal 1990, the budget deficit totaled $241.72 billion, with about $38 billion attributed to expenses for the Resolution Trust Company (RTC). Spending is 12.8% ahead of last year; minus the RTC funds, spending is up roughly 9.2%. With one exception, total government spending has outpaced inflation in every year of the 1980s. The estimate for the fiscal 1991 deficit is a record $230 - $250 billion.



As Government Spending Continues To Grow
The Federal Debt Spirals Ever Upward

A budget agreement for fiscal 1991 is no easy task. The economy is fragile, the capital markets have lacked enthusiasm since the crash, the props of U.S. investment in the 1980s are dwindling, and the deficit reduction efforts of past years (criticized by some as being based on "smoke and mirrors") have borne little fruit. The Mideast crisis exacerbated these factors and limited policy options further.

Traditional economic theory prescribes lower taxes and higher government spending to shake an economy out of the doldrums, particularly when the economy is softening and threatened by recession. Nevertheless, policymakers have sought instead to reduce the deficit by a combination of raising taxes and lowering spending. Despite the current economic scenario, we believe such a strategy may be warranted. Many individuals believe that the deficit and its financing act as a strong fiscal drag on the economy. Moreover, most of the working population has lost confidence in government spending and view reductions in expenditures as a positive factor even in soft economic times, especially if taxes can be kept down.

The appropriate time to have focused on deficit reduction was when the economy was stronger, so that reduced government spending and higher taxes would have been more tolerable to various groups. Nevertheless, we believe deficit reduction will give the financial markets comfort because of the drain of large, protracted deficits. Deficit reduction is particularly timely, given more and more evidence that the U.S. markets in the 1990s will not enjoy the cushion of foreign capital.

Tax rates were lowered in the 1980s, in the early years of the Reagan presidency and later by the Revenue Act of 1936. As an offset to lower rates, the income tax base was broadened. Taxes, as a percentage of adjusted gross income (AGI), declined from about 16% in the early 1980s to about 14% by 1988, indicating that the increase in individual income taxes was not as rapid as the increase in AGI. For example, individual income tax receipts (liabilities) rose from $256.3 billion to $433.2 billion in 1988, or 1.7 times. Over the same period, AGI grew from $1,613.7 billion to $3,097.3 billion by 1988, or 1.9 times. Thus, AGI rose about 12% faster than individual income taxes. This analysis, of course, ignores significant increases in social security taxes and other taxes such as state and local tax burdens. Few individuals feel their overall tax burden has declined in recent years.

Most of the arguments about reduced progressivity in our tax structure fail to consider that there has been substantial upward movement of taxpayers through the income distribution. Although the very top income classes enjoyed a significant increase in their share of income, so too have they paid a larger share of individual income taxes. For example, the $100,000+ group accounted for 15.3% of income taxes in 1980 and 35.6% in 1988 as their tax liabilities rose from $39.2 billion to $154.3 billion.

All of the income classes above $50,000 saw their increase in income taxes lag their income increase. At the same time, the decrease in the share of income tax paid by the under $50,000 income classes exceeds their decrease in share of income. In other words, the average tax rate for all income classes declined from 1980-88. Admittedly, the decrease was greatest for the top income classes -- exactly the purpose of the pro-growth income tax reductions of the 1980s.

Tax policy attempted to foster economic growth and job participation -- and it worked. Given the effectiveness of earlier policies, some policymakers are now criticizing the reduction in progressivity of the income tax structure. However, "class warfare" makes little sense for a country needing both economic growth and additional savings and investment.

One of the main stumbling blocks to restoring tax incentives has been the question of the distribution of income. The "soak the rich" mentality -- with the "rich" redefined in income terms for the IRA and capital gains debate -- is an extremely narrow one. If those with the discretionary funds to save and invest respond positively to tax incentives to do so, the focus of policymakers should be on the benefits that savings and investment provide -- economic growth and jobs. Clearly, economic incentives are part of the prescription for what ails the economy.

Some argue that, given the slide of the personal savings rate in the 1980s, savings and investment incentives such as the IRA and lower capital gains taxes were not effective. However, savings behavior is influenced by many factors and some researchers have concluded that without these policies, the savings rate would have been even lower.

Late last year, SIA undertook a survey of executives with Opinion Research Corporation (ORC) to determine their response to tax proposals affecting savings and investment. While the survey responses cannot be extrapolated to the entire population, the responses indicate how individuals who make frequent investment decisions and have discretionary income would respond to tax policy changes. The results of the SIA/ORC survey are summarized on the following pages. We believe these results support the historical evidence about how critical tax incentives or disincentives are in encouraging or discouraging savings and investment.

Reduction in the Capital Gains Tax Rate

The 1986 tax act contained the largest increase in capital gains taxes in history; a 65% increase for investors in the top tax bracket and an even greater increase for some middle income investors. Prior to 1987, the taxation of inflationary gains and the capital loss limitation were mitigated by the capital gains exclusion. Elimination of the exclusion increased the bias against long-term equity investment.

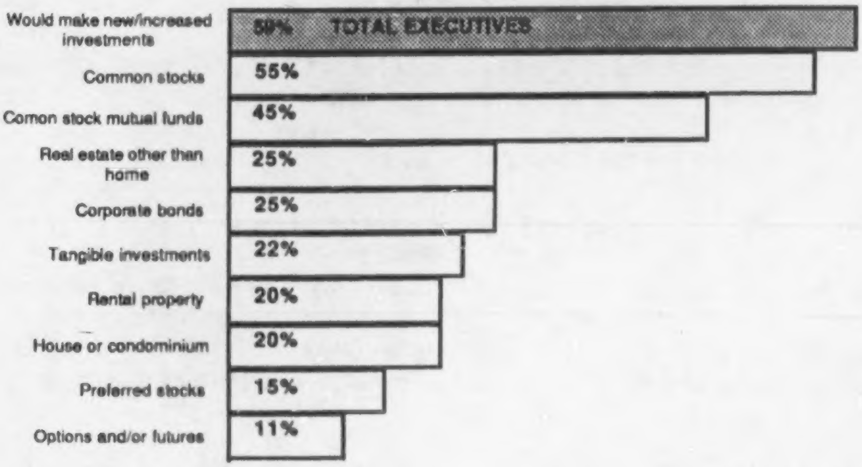
The current return from equity investment, dividends, is subject to both a corporate and individual tax. A capital gain on that same investment, to the extent the gain stems from the reinvestment of corporate income, is also taxed twice. In addition, the limitation on capital losses is both asymmetrical and inequitable. Although net capital gains are taxed as ordinary income, investors suffering *net* capital losses remain limited to only $3,000 in deductions against ordinary income annually.

One of the key positions taken by opponents of lower capital gains taxes is that the investor has the benefit of deferring tax on gains until realized. Several articles published recently in the Wall Street Journal walked through the exercise of determining the real return to investors on several different types of investment. For example, $1 invested in the stock market in 1970 would have grown to $8.90 by the end of 1989. However, deducting transaction and management costs, income taxes on dividends (calculated at a 28% rate for each year), capital gains taxes, and inflation leaves the investor with $1.63.[1] A dollar invested in fixed income produced even lower returns. These returns are hardly an incentive for risk taking. Another author contends that the capital gain tax environment -- with an effective capital gains rate of 75% for a portfolio purchased in 1975 and sold today -- destroys the incentive to make new risk investments while imposing a prohibitive cost on cashing in mature investments.[2]

But, revenue consequences aside for the moment, the major controversy surrounding a capital gains cut in today's debate is who benefits. There are both direct and indirect beneficiaries of lower capital gains taxes. Indirect benefits from equity investment flow to the economy through expansion. Direct benefits -- capital gains realizations -- are enjoyed by a wide strata of Americans. It is estimated that nearly one half of all taxpayers report capital gains during their lifetime. A study by the Joint Tax Committee found that in the 5-year period 1979-83, 44% of taxpayers realized gain in one of those five years. On the other end of the spectrum, 16% of taxpayers realized gains in each year.

A reduction in the capital gains tax rate to 20% with a one-year holding period would spur 55% of the executives in the SIA/ORC survey to increase investment in common stock, with the mean investment amounting to $20,800. Common stock mutual funds would also benefit as 45% of the executives said they would respond positively. Of the nine investment vehicle choices, common stock and common stock mutual funds were the first and second selection of executives for increased investment.

INCREASED INVESTMENT DUE TO REDUCTION OF THE CAPITAL GAINS TAX



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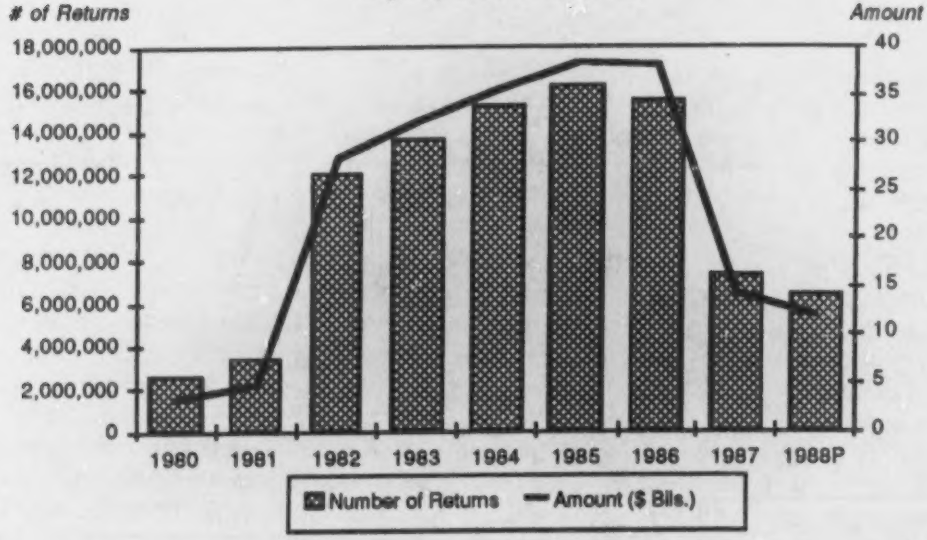
[1] *"How Taxes and Costs Prey on Nest Eggs,"* Wall Street Journal, September 25, 1990.

[2] *"The Real Capital Gains Rate -- 75%,"* Wall Street Journal, September 17, 1990.

Individual Retirement Accounts/Family Savings Plan

With its "up front" tax deduction and tax-free-until-withdrawn accumulation of earnings, the Individual Retirement Account (IRA) proved an extremely popular savings incentive. The 1981 tax act expanded IRA eligibility because of congressional concerns about the level of savings generally and the desire to provide a discretionary retirement vehicle for all taxpayers. In 1982, contributions to IRAs were claimed on 12 million returns attracting about $28.3 billion in savings. In peak year 1985, IRA contributions of $38.2 billion were claimed on 16.2 million returns. The 1986 tax act curtailed the tax deductibility of IRAs for most individuals. By 1988, with the restrictions of the IRA tax deduction, the number of returns claiming IRA contributions dwindled to 11.9 million and the amount of IRA savings, to $6.4 billion. Clearly, since the loss of the IRA tax deductibility, IRA participation has dropped sharply.

INDIVIDUAL RETIREMENT ARRANGEMENTS
Adjustments to Income



The link between IRAs, other savings incentives, and aggregate savings is still being questioned. However, studies by Professors Venti and Wise of the National Bureau of Economic Research show that IRAs provided a powerful savings incentive.[3] Among their findings was that one-half of all IRA deposits represent new savings, while about 30% comes from the taxes individuals save by making IRA contributions. Only 20% of deposits were funds shifted from other savings, given the penalty for early IRA withdrawal.

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[3] *"The Evidence on IRAs"*, Steven A. Venti and David A. Wise, Tax Notes, January 25, 1988.

Moreover, relating to who benefits, Venti and Wise found that 90% of individual contributions and 70% of contributions from families were from those earning less than $50,000 annually. The professors concluded that expanding the IRA contribution ceiling would generate significant new savings: about two-thirds of increased IRA deposits would represent new savings, with most of the balance being taxes individuals save through IRA contributions.

Professors Feenberg and Skinner developed additional evidence on the net savings effects of IRAs.[4] The professors used reported taxable interest and dividends as a proxy for non-IRA savings to test the hypothesis that the returns from non-IRA savings would be reduced if IRA depositors shifted savings. Their research found that from 1981 to 1984, the taxable interest and dividends of IRA depositors increased and rose by *more* than for non-IRA depositors. Hence, new IRA deposits were not shifted from other savings but represented new savings.

The work of Feenberg and Skinner as well as Professor Summers of Harvard also concluded that there was a positive psychological effect on savers due to the IRA advertising campaigns of banks, brokers, etc. The evidence suggests that the massive advertising undertaken for IRA accounts heightened public awareness of the need to save.

Proposals to once again expand the availability of IRAs have been made, but most would not restore the "up front" tax deductibility of these savings vehicles because of revenue considerations. Some proposals, while more generous than current law, would nevertheless limit availability by income. Indeed, even the availability of the Family Savings Plan would be restricted by income.

The SIA/ORC survey found that executives would be most responsive to an IRA-type savings plan. Based on an early version of the Administration's Family Savings Plan, executives were surveyed as to their response to a 10-year savings vehicle exempting earnings as they build and when funds are withdrawn. Contributions would be limited to $5,000 annually with a penalty on early withdrawals.

Seventy percent of the executives said they would open these new savings account. As to the source of funds for this new 10-year account, 12% indicated the funds would represent shifted savings, 16% said the funds would be new savings, and 41% claimed monies saved would be a combination of shifted and new savings. Of those responding positively to the savings plan, 41% preferred an immediate tax deduction and 28% preferred the tax exemption of accruing earnings. This IRA-type proposal drew the strongest support from younger executives.

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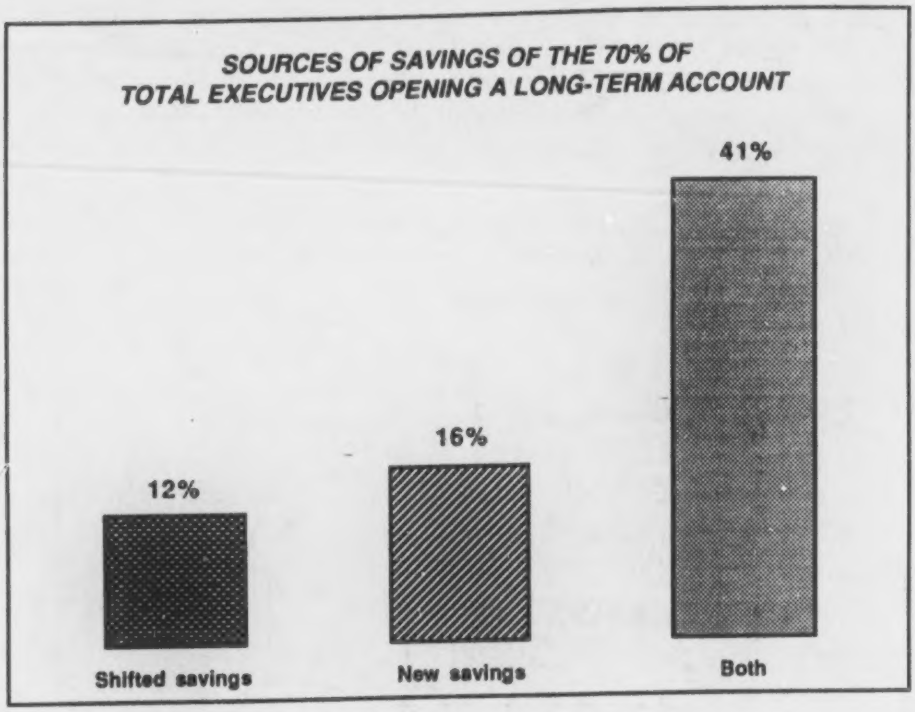
[4] *Sources of IRA Savings*, Daniel Feenberg and Jonathan Skinner, National Bureau of Economic Research, October 1988.



Double Taxation of Corporate Earnings

The M&A buyout craze of the 1980s highlighted the long-standing debt bias in the tax code. The anti-savings slant, or debt bias, is most apparent in the disparate treatment of corporate debt and equity. While interest payments are fully deductible by corporations, dividends are distributed out of taxable earnings and are taxed again to shareholders. Both debt and equity play a role in corporate finance, but there is no logical reason for the tax code to discriminate against either.

The issue of the 100% deductibility of corporate interest paid and the double tax on dividends has gone untouched despite recent revampings of the tax code. Corporate dividends paid to shareholders are subject to a maximum 56% effective tax rate (34% on earnings at the corporate level and 33% on the after-tax amount received as dividends by some shareholders).[5] On the other hand, interest payments are deductible by the corporation and payments to taxable entities are subject to a tax of 34% and to individuals, 33% Indeed, even though tax reform lowered individual and corporate tax rates, there remains a substantial tax discrepancy between the treatment of dividend and interest payments. A dollar of interest paid costs a corporation 66¢ in after-tax terms, whereas a corporation has to earn $1.34 to pay a dollar of dividends.

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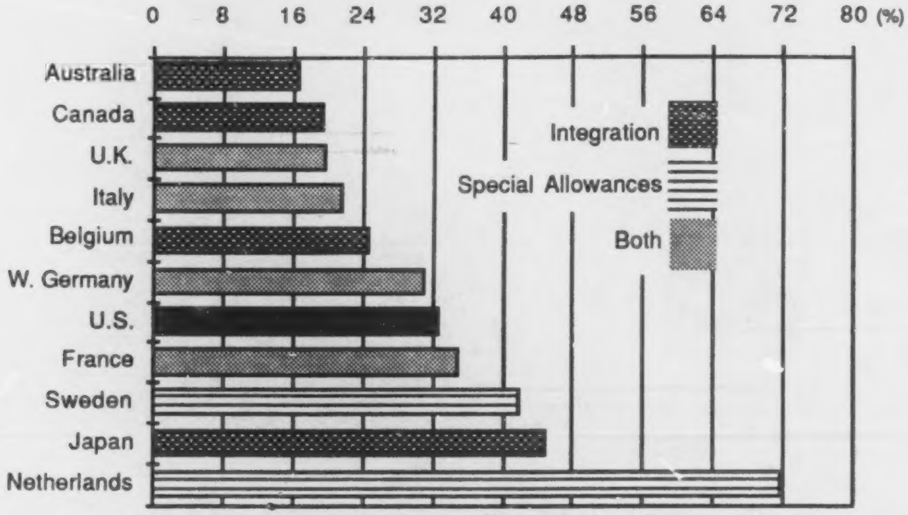
[5] .34 + .(66 (.33))=.34 + .22=.56

Most industrialized countries have some form of integration of corporate and individual taxes to mitigate the double tax burden. A 1989 survey of 10 major foreign countries by SIA/Spicer & Oppenheim found that eight have adopted some type of integration.[6] For six of these eight countries, integration produces effective tax rates below the maximum marginal U.S. tax rate on dividend income, ranging from 16.8% in Australia to 31.3% in West Germany.

Maximum Marginal Or Effective Tax Rates On Dividend Income In Industrialized Countries



The congressional hearings on LBOs early in 1989 touched on the double taxation of dividend income. Both Federal Reserve Chairman Greenspan and Secretary of Treasury Brady commented that there is a clear need for dividend taxation relief, but revenue considerations limit that relief. Treasury is currently preparing a study on the corporate tax structure, including a discussion of the double tax problem but reportedly with no recommendations for policy change. However, proposals have been made which would take a first step in balancing the tax treatment of debt and equity. Representative Bill Gradison, with analysis from the Joint Committee on Taxation proposed an 80% deduction for both interest and dividends on the premiss that this proposal would equalize the treatment of capital without affecting tax revenues and, hence, the deficit.[7]

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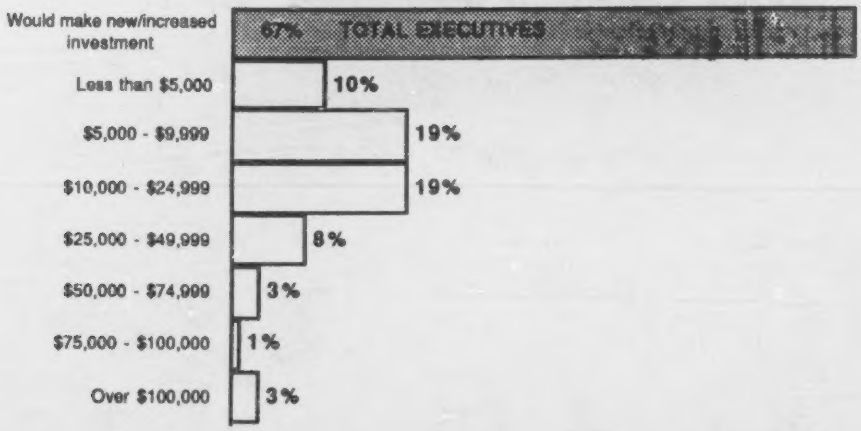
[6] *International Tax Comparisons*, SIA/Spicer & Oppenheim, 1989.

[7] Stated alternatively, the ratio of corporate dividend payments to corporate interest expense is about 1 to 4. The revenue increase resulting from a 20% disallowance of the deduction for interest paid would be equal to the revenue decrease resulting from an 80% dividend paid deduction.

A dividends paid deduction coupled with a smaller interest paid disallowance may be a starting point for tilting the tax code away from a debt bias. For the corporation, a partial deduction for dividends paid lowers the tax burden on dividends and makes equity financing cheaper. In contrast, disallowing a portion of the interest paid as a corporate deduction makes debt financing more expensive. For the individual, there should be more of an incentive for equity investment in that dividends will not be subject to the full corporate tax and, other things constant, such distributions would increase. In other words, the return on equity investment would be enhanced.

The SIA/ORC survey questioned executives as to a form of integration that would give shareholders a partial credit, 50%, for federal income taxes paid by the dividend-paying corporation. Responding to this proposal, 67% of the executives say they would make new or increased investments in common stock or common stock mutual funds. The mean investment for these executives was $22,700.

CHANGES IN COMMON STOCK AND COMMON STOCK MUTUAL FUND INVESTMENT DUE TO RELIEF OF DOUBLE TAXATION OF DIVIDENDS



Corporate America has been perceived as opposing tax integration because of the threat of increased shareholder pressure to pay out dividends. Surveyed executives of publicly-owned companies (82% of sample) were asked if they believed their corporation would favor dividend relief at the shareholder or corporate level. The response was overwhelmingly positive. Seventy-nine percent of the executives believe their corporate employer would favor dividend relief at the shareholder level and 84% believe their company would favor relief at the corporate level.

Tax on the Purchase and Sale of Stock

The securities transaction excise tax (STET) has been considered as a tax option by policymakers from time to time. In recent years, congressional concerns over market volatility and the perceived short-term focus of corporate management gave momentum to this tax proposal. Notably, the STET was under serious consideration by the Administration in the crafting of the 1991 fiscal year budget package.

Many organizations, including SIA, and individuals weighed in with analysis of the impact a STET would have on investors, markets, and the economy. SIA's analysis noted the STET is one of the poorest tax policy options as it impacts savings channeled to our capital markets.[8] Rather than being a progressive tax which falls on the wealthy, a STET would erode the savings and retirement funds of millions of pensioners and mutual fund shareholders. While eroding individuals' savings, the STET would increase the cost of capital for U.S. corporations. The U.S. already fares poorly in terms of capital costs when compared with its major international competitors. Moreover, of 15 industrial countries surveyed, five have either lowered the rates of such taxes recently or are in the process of phasing out the tax completely. Six countries do not have the tax, while four see no threat to their capital markets from global pressures.

With good reason, the STET was not included in the budget summit agreement. Since the STET was first considered, the Mideast crisis and increasing evidence of a sluggish economy have taken their toll on the market. Several analysis concluded that the STET would have a further dampening effect on market volume and prices as well as economic growth.

TAX ON PURCHASE & SALE OF STOCK

45% of Total Executives Would Decrease Transactions	% Decrease	36% of Total Executives Would Reduce Net Investment
3%	Under 5%	2%
6%	5%-9%	5%
11%	10%-19%	7%
10%	20%-29%	11%
16%	30%-100%	11%

The SIA/ORC survey polled executives as to their reaction to a 0.5% tax on the value of the purchases or sale of common stock. Forty-five percent of the executives indicated that they would decrease their stock transactions if this tax were implemented. Among those who would do so, the average decrease in stock transactions was 27.5%. Thirty-six percent of executives also indicated that they would reduce their net investment in common stock, with the average reduction about 26%. Some 53% of the executives would shift their investment from common stock to other investments. All told, the reactions of executives in the SIA/ORC survey supported the projected negative impact of a STET as indicated by several studies.

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[8] See *"Securities Transaction Excise Tax: Wrong Tax, Wrong Time, Wrong Place,"* Trends, SIA, August 22, 1990.

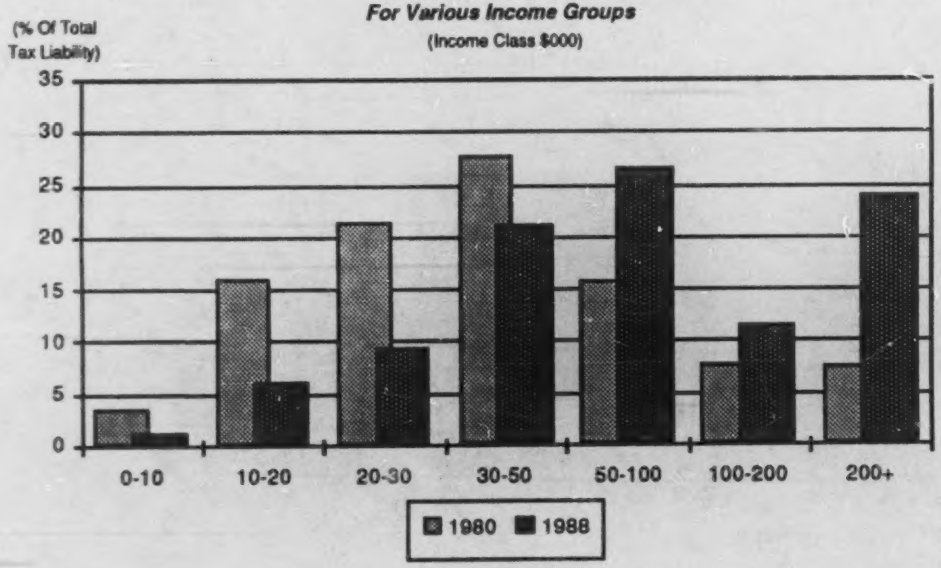
Conclusion

Deficit reduction and pro-growth tax incentives are necessary to get the economy back on a long-term growth track. Recently, both political parties are stressing politics rather than economic fundamentals. In other words, class warfare has become as important as deficit reduction.

The major conceptual flaw in the various tax bills is the claim to directly or indirectly increase taxes on the "rich." There are few people that consider themselves rich simply because their income exceeds $100,000 or $200,000. For example, it doesn't take much for a married professional couple -- doctors, lawyers, consultants, etc. -- to reach these income levels. Nothing is said in these tax bills about wealth -- the traditional measure of affluence. Rather, the proposed tax bills, like others before, strike at the same group as earlier tax increases, the high income working families.

Political infighting over which class bears the tax burden is obscuring consideration of policies proved effective in stimulating the economy. European history is full of lessons about the results of class warfare. Today, the income groups $50,000+ pay a much larger share of the income tax burden than was the case in 1980. This group is also a much larger percentage of taxpayers today (12.7% in 1988) than in 1980 (3.3%). More than anything else, this reflects the rapid upward move in income distribution throughout the 1980s as individuals and families moved into higher brackets, a desirable result of economic growth.

Distribution Of Tax Liability
For Various Income Groups
(Income Class $000)



The year 1990 seems to have brought the holiday of the 1980s to an abrupt end. The last thing needed now is fiscal policy based on class warfare. It takes tough and confident leadership to make the hard choices to provide for a growing, stable economy. High spending, high taxing governments have never provided the environment necessary for sustainable economic growth. We believe Congress and the Administration should choose pro-growth policies over income redistribution because in the longer run we will be left with an economy more able to provide for all. It would be a Pyrrhic victory, indeed, if economic growth were stunted because of class warfare.

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1

VOLUME

	SEP. 1990	YTD 1990	SEP. 1989	YTD 1989	% CHG YTD 1990-1989
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	141.3	156.8	151.8	166.1	-5.6%
AMEX (MILS.)*	11.7	13.8	12.6	12.2	13.1%
NASDAQ (MILS.)*	110.3	136.0	131.3	132.5	2.6%
REGIONAL EXCHANGE (MILS.)*	20.9	24.7	24.5	26.5	-6.8%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$82,787	$1,026,714	$120,174	$1,165,773	-11.9%
AMEX (MILS.)	2,562	30,218	3,977	32,295	-6.4%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	7,530	89,522	9,255	88,771	0.8%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	10,932	128,776	15,336	155,630	-17.3%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	48.4%	49.7%	49.0%	51.6%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	9,777	98,191	9,688	97,368	0.8%
AMEX OPTIONS	2,742	26,887	3,740	31,033	-13.4%
COMMODITY	20,488	210,647	19,888	204,497	3.0%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

PRICES
(END OF MONTH)

4

	SEP. 1990	SEP. 1989	% CHG SEP. 1990-1989
DOW JONES INDUSTRIALS	2452.48	2692.82	-8.9%
STANDARD & POOR'S 500	306.05	349.15	-12.3%
NYSE COMPOSITE	167.85	193.97	-13.5%
AMEX MARKET VALUE INDEX	307.72	388.76	-20.8%
VALUE LINE COMPOSITE	189.75	275.26	-31.1%
NASDAQ COMPOSITE	344.51	472.92	-27.2%

YIELDS
(MONTHLY AVERAGES)

2

	SEP. 1990	SEP. 1989	BASIS POINT CHG 1990-1989
BOND BUYER INDEX (20 BOND)	7.53%	7.26%	27
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	9.56	9.01	55
Baa CORPORATE	10.64	9.91	73
RATIO Aaa CORPS. TO Baa CORPS.	0.90	0.91	(1)

UNDERWRITING

	9 MOS. 1990	9 MOS. 1989	% CHANGE 1990-1989
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$237,383.5	$214,723.1	10.6%
Common Stock	$16,182.9	$15,002.1	7.9%
# of Common Stock Issues	336	308	9.1%
Preferred Stock	$3,610.3	$5,778.2	-37.5%
# of Preferred Stock Issues	66	75	-12.0%
Corporate Debt	$217,590.3	$193,942.8	12.2%
# of Corporate Debt Issues	956	1,056	-9.5%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$68,421.1	$64,783.5	5.6%
# of Issues	3,022	3,785	-20.2%
Competitive	$22,675.9	$21,906.3	3.5%
# of Issues	2,555	2,602	-1.8%

Source: Securities Data Co.

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
SIA Fact Book -- The Securities Industry of the Eighties	Fact Book designed to provide a decade of data on the most frequently asked questions on the securities industry and capital markets. In 31 pages of tables and charts, the book covers various aspects of the securities industry including: the brokerage community, capital markets, stock market activity, mutual funds, futures and options, retail and institutional trading and holdings, economic data and vital foreign market statistics.	SIA Research Department Members: $25; Others: $50
Report on Office Salaries	SIA's annual report presents data on 79 non-exempt positions in 57 SIA member firms employing over 132,500 individuals. Job categories include secretarial, sales assistant, administrative, clerical and operations positions. Among other data, this 218-page report contains tables illustrating weekly office salaries of 1990 compared with 1989 levels to illustrate percentage changes.	Pamela Faber Surveys Manager Members: $450 to $675 Others: $1,400 first copy, $50 additional copies
"Corporate Finance - Third Quarter Rankings"	The crisis in the Middle East, lingering recession fears, and woes in the banking system put a damper on debt and and equity issuance in the third quarter. But, for the 9 months of 1990, overall volume rose on strength in the mortgage- and asset-backed arenas. As a result of a 26.5% jump in MBS issues and a dramatic 207% rise in the in ABS over 3rd quarter volumes in 1989, new issue volume for the first 9 months of 1990 was up 9.3% to $237.4 billion from $217.1 billion. Manager ranking data for domestic and foreign issues.	Investment Dealers' Digest October 8, 1990
Indexing Capital Gains	This study considers the advantages and disadvantages of one option for reducing the tax burden on capital gains -- indexing gains for inflation -- as compared with the options of excluding some part of capital gains from taxation or continuing the treatment of capital gains under present law. Topics discussed include: how indexing and exclusion affect different kinds of capital gains assets, distributional effects, and factors affecting revenue under indexing as compared with 30% exclusion. Study makes no recommendations.	Congressional Budget Office

Item	Description	Source
How We Stack Up	Booklet designed as a handy reference tool demonstrating the impact of state fiscal policy on the New York economy. The 31-page booklet is divided into 2 main sections, economic indicators and taxes and spending, and shows New York's standing versus the other states. For example, New York ranks second in a comparison of total state and local tax burden per capita.	The Public Policy Institute of New York State, Inc. 152 Washington Ave. Albany, N.Y. 12210 $2.50 per copy
Electronic Bulls & Bears: U.S. Securities Markets & Information Technology	This report assesses the current use of information technology by U.S. securities exchanges and OTC dealers, by related futures and options markets, and by associated industries and regulatory agencies. While finding that the U.S. markets are the most efficient in the world, report concludes there are still serious problems to contend with in the future. Some of these problems result from the reluctance to accept technologies that may threaten traditional roles.	Office of Technology Assessment Superintendent of Documents U.S. Government Printing Office $10
"The curse of checks and balances"	The Economist looks at the recent budget process in the U.S. Rejecting constitutional or party reform, authors find forcing Congress to be more responsible about spending as an easier solution. Incentives to force this turn of events include: linking a Congressmen's pay to the size of the deficit in the previous year -- the bigger the deficit, the lower their pay.	Economist October 13, 1990
"1990 All-America Research Team"	Annual selection of brokerage analysts who have done superior work during the past year ranks 462 analysts from 34 firms. In terms of total team positions, Shearson Lehman took the number 1 spot from Merrill Lynch; Goldman Sachs held on to the number 2 position; and Merrill Lynch dropped to number 3 from last year's top place.	Institutional Investor October 1990